REPORT BY THE STATE AUDITOR

OF CALIFORNIA

REVIEW OF THE IMPLEMENTATION, ADMINISTRATION, AND PLANS FOR TERMINATION OF THE CALIFORNIA RESIDENTIAL EARTHQUAKE RECOVERY PROGRAM

93013 **April 1994**

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April 5, 1994 93013

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

The Bureau of State Audits presents its audit report prepared under contract with Ernst & Young concerning the implementation, administration and plans for termination of the California Residential Earthquake Recovery Program. This report concludes that the essential purpose of the program was fulfilled. The Department of Insurance (department) completed the basic functions necessary to ensure that claim payments were made and funds were controlled. However, the department's performance in specific aspects of the implementation, operation, and termination of the program lacked consistency and/or effectiveness, sometimes for reasons beyond its control.

Respectfully submitted,

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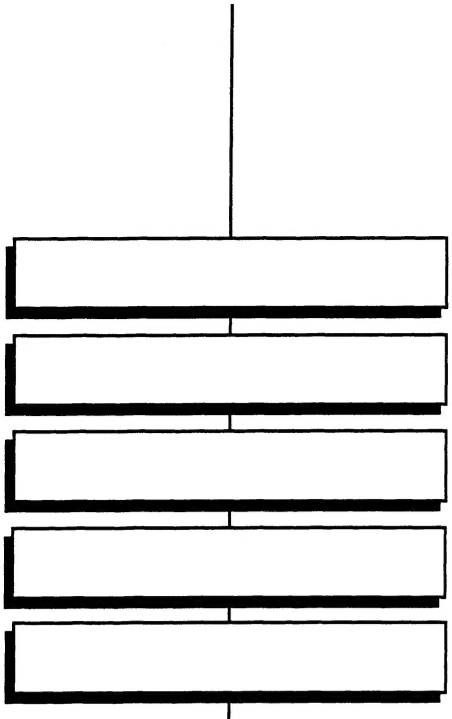

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Bureau of State Audits

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April 5, 1994

ERNST & YOUNG

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Summary

Results In Brief

The California Residential Earthquake Recovery (CRER) Act of 1990, as enacted, was intended to provide payments to residential property owners for structural damage caused by earthquakes. Funding relied on surcharges to be billed to and collected from insurance policy holders by insurance companies, and subsequently remitted to the state for deposit in the CRER Fund (CRERF). The program became operational January 1, 1992, but repeal legislation was enacted in September 1992 which established the official program termination date as December 31, 1992, only one year after implementation. The repeal legislation required pro rata refund of all surcharge revenue not needed for claims and related administrative expenses.

This report documents various strengths and weaknesses in the program's structural design and the subsequent development, management, operation, and termination of the CRER Program by the California Department of Insurance (DOI).

Our overall conclusion is that the *essential* purpose of the program was fulfilled. The Department completed the basic functions necessary to ensure that claim payments were made and funds were controlled. Given the unusual circumstances surrounding this program, this is a noteworthy accomplishment. However, the Department's performance in specific aspects of the implementation, operation, and termination of the program lacked consistency and/or effectiveness, albeit sometimes for reasons beyond its control. The program's strengths and weaknesses are highlighted below and are discussed in detail in the various chapters of this report.

The program was developed and operated within an unusually difficult and unstable environment. The open discussion of potential repeal and the lack of surcharge collection enforcement provisions were two key extenuating circumstances. These and other factors should be considered when evaluating the Department's management of the program; however, they do not fully explain or justify certain important deficiencies in program management and operation described herein.

Our findings indicate that the surcharge collection process was inefficient and unduly complex. However, the problems related to surcharge collections were primarily structural in nature and, for the most part, beyond the Department's control. In particular, lack of enforcement provisions in the authorizing legislation left the

program with an unpredictable and unstable source of funding. This fundamental weakness also contributed to various data collection problems related to policy holder information which, in turn, resulted in the less-than-planned effectiveness of the CRER Information System.

The most significant deficiency identified during this evaluation was that the Department did not adequately perform its contract management functions. A five-year, $66 million contract was issued to Computer Sciences Corporation (CSC) to design and implement the CRER Information System, and to provide fiscal intermediary and claims adjustment services. Based upon our review, it does not appear that the Department (1) effectively monitored contractor performance and charges, (2) ensured that contractual requirements were met before major invoices were paid, and (3) established reasonable performance criteria for payment of termination services. These issues are particularly important because the majority of the program's implementation, operation and termination activities were conducted by CSC. During the shortened life of the CRER Program, the Department actually paid a total of $32.6 million for system development, fiscal intermediary, claims adjustment, and termination services. Moreover, it now finds itself in a contract dispute with CSC, necessitating the hiring of outside legal counsel and a litigation support contractor, and establishment of a reserve of $500,000 for potential litigation. Conceivably these developments could have been avoided or ameliorated through more effective contract management.

In reviewing the claims adjustment process, we found that claim payments for damages were calculated accurately. However, various other aspects of CSC's claims processing failed to meet requirements established in program regulations or policies. Specifically, the documentation of claimant eligibility was inconsistent in the claim files, and the amount of time required for CSC to process claims exceeded the maximum time limit established by the program's regulations in more than half the files in our sample of 393 claims.

The pro rata refund methodology used by the Department was reasonable. As part of the methodology, the Department prudently established reserve accounts for activities which could not be completed by the time refunds were issued. In addition, the Department's review of the actual refund payments calculated by CSC was reasonable, although it was not formally documented. In addition, the various documents which described the pro rata refund

methodology were not adequately integrated to fully describe the process. Based on information provided by Department, the CRER Program does not appear to have any unfunded liabilities.

Finally, our findings indicate that the Department's performance of certain administrative tasks was inconsistent, largely due to insufficient staffing. The potential repeal of the CRER Program clearly impacted the Department's decision to forego staffing two-thirds or more of the planned program management unit. Nevertheless, some important functions were not performed or were scaled back due to insufficient staffing, most notably contract management activities and certain fiscal and audit functions.

Background

Senate Bill 2902 (Chapter 1165, Statutes of 1990) created the Green, Hill, Areias, Farr California Residential Earthquake Act which established a basic, mandatory earthquake disaster relief program covering structural damage of up to $15,000 for owner-occupied dwellings. The California Residential Earthquake Recovery (CRER) Program and its related CRER Fund are administered by California Department of Insurance (DOI).

The coverage provided by this program was paid through an annual surcharge on homeowner policies, ranging from $12 to $60. The amount of the surcharge was determined by the Department, but it was billed, collected, and forwarded to the state for deposit in the Fund by the insurers providing homeowners policies. Money in the Fund could be used to pay earthquake insurance claims, fund administrative and adjustment expenses, purchase reinsurance, and selected other purposes.

The Department of Insurance was charged with implementing and administering the CRER Program. This included collecting surcharge revenue and policy holder information, as well as processing claims. To assist in implementing this major new program, the Department awarded Computer Sciences Corporation (CSC) a five-year, $66 million, turnkey contract to provide fiscal intermediary (FI) and claims adjustment firm (CAF) services. CSC had broad responsibilities for most program functions.

Assembly Bill 2049 (Chapter 1251, Statutes of 1992) repealed the California Earthquake Recovery Act. The bill provided for payment of claims which were submitted prior to the Act's repeal, and stated that any money appropriated to the Department for administration of

the Act would be used to terminate the program. Thereafter, money remaining in the Fund was to be rebated to policy holders on a pro rata basis.

A summary of the major dates and timeframes associated with this unique program is provided below:

- September 1990: Enabling legislation becomes effective and sets July 1, 1991 as the start date
- June 1991: Program start date extended to January 1, 1992
- August 1991: CSC initiates development of the CRER Information System and related program requirements
- January 1, 1992 through December 31, 1992: Period of program operation
- February 1992: Repeal legislation introduced
- September 1992: Repeal legislation becomes effective
- January 1, 1993 through March 31, 1994: Overall program termination phase.

Methodology

In conducting this evaluation, a variety of approaches were employed. Interviews were conducted with both current and former CRER program managers, representatives from the program's primary contractor, and both current and former program staff members. In addition, we conducted interviews with members of other organizations which are currently conducting or have previously performed reviews of the CRER Program, including the State Controller's Office and R & G Associates. In evaluating the program's claims processing function, we reviewed a sample of 393 claim files to determine the accuracy and effectiveness of this program component. We also evaluated various other documents, reports, correspondence, etc., related to specific aspects of the program.

All of these efforts were directed toward assessing the performance of the Department in implementing, administering, and planning for the termination of the California Residential Earthquake Recovery Program. This review was conducted to address the audit requirements identified in Assembly Bill 2049 and included the following significant objectives:

- Determination of whether the Department established the required regulations, rules, systems, policies and procedures to implement the Act
- Evaluation of the efficiency and effectiveness of claims processing
- Evaluation of the termination of the program.

The Fundamental Purpose Of The Legislation Was Accomplished Despite The Lack Of Enforcement Authority And Program Stability, And Other Related Problems

The basic intent of the CRER program was to provide payments to residential property owners for structural damage caused by earthquakes. Our overall conclusion is that the essential purpose of the program was fulfilled in that surcharge payments were collected and claims were processed accurately. Given the unusual circumstances surrounding this program, this is a significant accomplishment.

The environment in which the program was developed was unusually difficult and unstable. These extenuating circumstances included (1) the lack of enforcement provisions for the collection of surcharges, (2) open discussions of the potential repeal of the program before it started operations, (3) a change in DOI administration, (4) constraints on the Department's ability to hire and retain staff, and (5) limited fiscal intermediary contracting options. Although these extenuating circumstances clearly impacted the Department's decisions affecting administration and operation of the program, they do not fully explain or rationalize the deficiencies in program management and operation that are identified in this report.

The Surcharge Collection Process Was Unduly Complex, Primarily For Reasons Beyond The Department's Control

The CRER Program's authorizing legislation required that all eligible homeowners pay the earthquake program surcharge and that insurers add the surcharge to policy billings, for properties covered by the program, and transmit the surcharge to the state. However, the authorizing legislation did not include enforcement provisions to ensure compliance with these requirements by homeowners or insurance companies.

The lack of adequate enforcement provisions presented a number of challenges and problems related to program implementation. Some insurance companies refused to participate or, at a minimum,

provided less than satisfactory compliance with DOI requests. Requirements related to monthly submission of surcharge revenue, interest, and policy holder data sometimes were ignored or not properly fulfilled by insurers. The insurance companies also had to redesign automated systems to accommodate the new governmental surcharge collection and data reporting requirements. This work often was costly and, in many instances, resulted in late, incorrect, and/or improperly formatted data submissions to CSC. In turn, these problems contributed to the general inefficiencies associated with the surcharge collection process and the less-than-planned effectiveness of the CRER Information System.

The lack of enforcement also resulted in only 69 percent of eligible homeowners participating in the program. Accordingly, the risk and administrative costs of the program were unfairly spread among this smaller group (i.e., about 4.6 million out of an estimated 6.7 million homeowners).

The Department Did Not Adequately Perform Its Contract Management Functions

The implementation and operation of the CRER Program was largely conducted by Computer Sciences Corporation in its role as the fiscal intermediary and claims adjustment firm. Because of the significance of this role and the size of CSC's contract, effective management of the contractor's activities was important. However, in several key respects the Department's contract management was not adequate or effective, as outlined below:

- Basic contract oversight and management activities were planned but often not performed, in part because of insufficient staffing of the contract management unit

- Some CSC invoices -- including one for over $2 million -- were paid without ensuring that all contractual requirements and sign-offs had been completed

- The termination agreement with CSC did not link deliverables or performance criteria with payments

- Some of CSC's claims processing requirements were not monitored and/or not enforced by DOI.

There were extenuating circumstances associated with DOI's contract management approaches, particularly the decision to leave four of five budgeted contract management positions vacant after

April 1992. Nevertheless, these factors did not obviate the need to (1) monitor contractor performance and charges more closely, (2) ensure that contractual requirements were met, and (3) establish reasonable performance criteria for payment of services. If the primary contract had been managed more carefully, the current dispute between CSC and DOI possibly could have been avoided, as well as the extra costs associated therewith.

Claim Payments For Damages Were Calculated Accurately But Various Other Aspects Of Claims Processing Failed To Meet Requirements Established By Regulations Or Policy

Over 14,200 claims were processed by CSC, with DOI review. According to the program's estimates, $53.4 million in benefits was paid out to approximately 8,300 homeowners to help repair structural damages from earthquakes in 1992. Our review of a random sample of 393 claim files found that claim payments were calculated accurately.

The CRER Program and its contractor fell short, however, in complying with the California Code of Regulations concerning the maximum time limits required for claims adjustment services in over half of the sample claims we researched. Regulations required that a claimant be notified in writing of the decision on his/her claim within 60 days from the date it was filed. Of the 374 claims with decision letters in our sample, 193 (51 percent), failed to meet these requirements. Our review showed that all versions of the decision letters sent to claimants were dated an average of 68 days after the claim was initiated. In addition, eligibility documentation and other paperwork in the files were inconsistent.

The Pro Rata Refund Methodology Used By The Department Was Reasonable And The CRER Program Does Not Appear To Have Any Unfunded Liabilities

The repeal legislation required the Department to refund surcharges paid by policy holders on a pro rata basis. The methodology used to develop the pro rata refund percentage and the process for reviewing refund amounts was reasonable. However, "formal" approval of the final methodology and refund check amounts was not fully documented, and the various documents which described the methodology were not adequately integrated, and thus did not fully describe the refund process.

As part of the process for determining the amount of the pro rata refunds, the Department had to establish reserve accounts to provide funding for activities which could not be completed by the time the pro rata refunds were issued in May 1993. These activities included

processing outstanding claims, conducting post contract audits, responding to questions related to the refunds, and concluding all program administrative activities. The Department has been reasonable and prudent in establishing these reserves, and it estimates that the Fund will have a balance of over $3 million after all outstanding activities have been completed. Based on the information provided by the Department, the CRER Program does not appear to have any unfunded liabilities at this time.

There Was Inconsistent Performance Of Program Administrative Activities, Primarily Due To Insufficient Staffing

The Department's implementation of various administrative aspects of the program was satisfactory or better in some circumstances and less than adequate in others. The Department did develop regulations and policies for the implementation of the CRER Program, and acceptable procedures were utilized to allocate departmental indirect overhead costs to the program. However, the program operated with significant understaffing which impacted the performance of several key functions. Of 36 DOI positions planned and budgeted for the program, during FY 1991/92, only 7.2 positions were filled. During FY 1992/93 an equivalent of only 14.3 positions were staffed. Again, there were extenuating circumstances affecting the Department's staffing decisions, particularly the threat of program repeal. These factors would appear to justify the decision not to fill all 36 budgeted positions. However, they do not seem sufficient to justify such extensive understaffing.

During the course of implementing, administering and ultimately repealing the CRER Program, the Department incurred administrative costs which totaled $39.9 million. This included the cost of developing the CRER Information System, collecting surcharges and policy holder information, processing claims, and terminating the program. This amount does not include the payment of claims. The administrative cost per policy holder was $8.67 and administrative costs represented 16.9 percent of the total surcharge revenue collected.

Agency Comments

In general, the Department agreed with most of the findings in the audit, particularly the finding that "Despite the Lack of Enforcement Authority and Program Stability, The Department Accomplished the Fundamental Purpose of the Legislation." However, the Department differed with certain specific statements, findings, and conclusions

included in the audit report. In particular, the Department differed with selected findings related to the contract management and claims processing functions. The Department's response to the audit is provided after Chapter 6 and is followed by the auditor's comments related to this response.

Introduction

Authorizing Legislation: History & Provisions Of SB 2902

Following the heavily publicized Loma Prieta earthquake which shook the San Francisco Bay Area in 1989, then Governor George Duekmejian proposed the creation of a state-run disaster relief fund specifically designed to assist residents in repairing damages sustained during earthquakes. The following year's legislative session yielded SB 2902, a bill authorizing the creation of the California Residential Earthquake Recovery (CRER) Fund.

The Green, Hill, Areias, Farr California Residential Recovery Act included the following provisions:

- Created the CRER Fund which would be administered by the Commissioner of Insurance and would offer payments to owners of residential property suffering significant losses due to earthquake damage. Property used for commercial purposes, owned by a public entity, or financed through the Cal-Vet Farm and Home Loan Program were not entitled to Fund benefits.

- Required insurance companies, agents and brokers to collect a surcharge on every owner-occupied residential property at the same time fire insurance policy premiums were collected. The amount of the surcharge was determined by each home's earthquake risk based on location, construction and year built, but had to be between $12 and $60 per year and listed as a separate item on the homeowner's bill. An additional fee of up to $1 per policy could be collected by insurers to recover their administrative expenses. This fee was to be itemized separately on the bill as well.

- Further required insurers to document the owner's name and identifying property information, and then turn over the money and records to the state. Insurers also were to keep track of those homeowners refusing to pay the surcharge who then would be ineligible to receive program benefits.

- Provided payments for specific losses of up to $15,000, less a deductible to homeowners who had paid the CRER Fund surcharge. The deductible equaled one half of one percent (.5%) of the amount of the property's fire coverage and could be no less than $1000 or no more than $3500. The Fund covered the costs of restoring homes to a habitable condition; however, the program did not assist homeowners with cosmetic repairs nor with damages to non-essential items such as garages, patios,

pools, etc. If homeowners had purchased private earthquake insurance separately, the Fund would pay only up to the total of the private insurance deductible, less the Fund's own deductible providing the damage was equal to that amount.

- Permitted the CRER Program to contract with private individuals or entities for claims adjustment services providing that the services only make recommendations to the Commissioner and that the Fund make the actual payments to claimants.

- Limited the liability of the State of California to paying out only the money in the CRER Fund. If claims from an earthquake were estimated to exceed the Fund balance, legislation allowed for distribution of benefits on a pro rata basis so that all claimants would receive the same percentage of their approved claim amounts.

- Directed the Department of Insurance to conduct a Small Business Coverage Study to evaluate the availability and adequacy of commercial insurance for assisting smaller companies with repairs and losses associated with earthquakes, and to present these findings to the Legislature.

- Allowed the Department to provide low-interest loans for the purpose of retrofitting structures to withstand or reduce earthquake damage or hazards. These loans could be granted to those who had residential property insurance in force. Loans could be granted once the fund had a balance of more that $1 billion. Because the program was only in place for one year, the fund balance did not reach $1 billion and loans were not granted.

- Established the California Residential Earthquake Recovery Fund Bond Committee. This committee included the Insurance Commissioner, the State Treasurer, the State Controller, and the Director of Finance. The Act authorized the committee to issue revenue bonds, negotiable notes, and bonds, pledging all or part of the revenues anticipated from the surcharges. However, any debt which was issued was not be considered a debt of the State of California. The Act authorized the committee to issue up to $1 billion in revenue bonds. During the year that the program was in operation, the committee did not issue any debt.

Administration Of The CRER Program

The Act charged the Insurance Commissioner with developing regulations and procedures for implementing the CRER Program. Though authorizing legislation was signed by the Governor in September 1990, efforts to implement the earthquake program were delayed due to the election that November of a new Insurance Commissioner. What had previously been a position appointed by the Governor became a statewide elected office under Proposition 103, which passed in 1989 and provided insurance reform. The resulting change in Insurance Department administrations delayed implementation of the Fund until the new Commissioner assumed responsibility for the Department. Pursuant to SB 289, the program became effective on January 1, 1992, rather than the July 1, 1991 date set forth in the original CRER Act. This was due to delays in obtaining funding for the start-up costs and the change in Commissioners, noted above.

Money in the CRER Fund could be used only for the following purposes:

- To pay earthquake insurance claims
- To fund administrative and adjustment expenses
- To purchase reinsurance
- To pay for any bond revenues that might be authorized
- To retrofit dwellings.

The CRER Program was not intended to be a substitute for private earthquake insurance, but rather a measure to make private coverage more attractive and affordable. Homeowners could choose to purchase private insurance with high deductibles of up to the program's maximum benefit of $15,000. The higher deductible would allow them to take advantage of lower premium rates. The program then would augment private insurance by providing coverage for the bulk of structural damage repair costs which fell below the private earthquake insurance deductible (assuming sufficient Fund reserves were in place). This additional payment from the Fund would minimize the out-of-pocket expense to the property owner while still preserving coverage for the full cost of major repairs through private insurance.

Insurance companies played a key role in the administration of the program by providing policy holder information and collecting

surcharges. Once collected, surcharge revenue had to be kept in an interest bearing account. These funds also had to be segregated from other insurance company receivables. All funds received, together with interest, had to be deposited with the State Treasurer within thirty days from the end of the month in which the surcharge was collected. Information identifying those policy holders who had and had not paid the surcharge also had to be submitted to the CRER Program contractor at the same time the receipts were deposited with the state.

In order to assist in implementing the program, the Department of Insurance awarded Computer Sciences Corporation (CSC) a full service, "turnkey" contract to provide fiscal intermediary (FI) and claims adjustment (CAF) services for the CRER Fund. CSC had broad responsibilities for nearly all program functions. The key services provided by CSC included:

- Designing, developing and operating an electronic data processing computer system to process policy data and claims
- Receiving policy and property data from insurers and verifying its accuracy as well as handling all other insurer relations issues
- Budgeting and administering CRER Fund accounts
- Receiving, inspecting, and processing claims from residents whose homes were damaged during an earthquake
- Assisting with claimants' appeals
- Preparing regular progress reports on program operations and performance
- Preparing ad hoc reports at the request of the Department.

As noted above, CSC managed the collection of policy holder and surcharge payment information. This process included receiving names transmitted by insurers of those from whom a surcharge was collected, and the names of insureds who failed to pay. This information was tracked in an automated system, based on the Department's specifications, which CSC developed as part of its contract.

Policy holder and property data input into the automated information system could be cross-referenced and retrieved to determine a claimant's eligibility status. Claimants who had not been billed by their insurance company and, therefore, were not yet in the system, were still eligible as long as they had fire insurance in effect for 1992, and were due to receive a bill for the CRER surcharge before the end of the calendar year. Residents making claims who had not yet been billed for the surcharge would simply have their surcharge payment deducted from their benefit check, if their claim was approved. If this occurred, they would not need to pay the surcharge again that year.

Data concerning surcharge and claims processing activities were included in the overall information system which CSC utilized to manage and operate of the CRER Program. This complex system included:

- An IBM compatible mainframe running over 200 custom written COBOL programs and housing over 40 million records for transaction processing
- A Unix-based super mini-computer used for reporting and actuarial analysis
- A local area network of approximately 90 personal computers with analytical tools and access to both the mainframe and the super mini-computer.

The investment made by the Department in developing and implementing this system was very significant and CSC played a major role in the implementation and administration of the program.

Subsequent Legislation

Several pieces of legislation were passed which impacted and modified the CRER Act. These included the following:

- SB289 (Green), passed in June 1991, amended the Act so that implementation of the program was delayed six months. This legislation allowed the program to begin providing benefits on January 1, 1992 instead of July 1, 1991.

- SB125 (Hill), passed in July 1991, required that claimants report damages from an earthquake within 90 days of the event in order to receive benefits. It also appropriated $430,000 for planning and implementation of the program, and revised some of the technical provisions relating to the program's authority to issue revenue bonds.

- SB412 (Hill), passed in October 1991, made technical changes to the definitions of residential property, qualifying structural damage, and qualifying earthquake events for the purposes of benefits. It allowed surcharges to be paid on an installment basis and required insurers to submit their collections monthly rather than quarterly. It also limited coverage for those whose policy renewal date did not occur in 1992.

Repeal Legislation: AB 2049's Main Provisions

Under the sponsorship of Assemblyman Isenberg and with the support of the Insurance Commissioner, AB2049 proposed to terminate the CRER Fund as of January 1, 1993. It passed both houses and was signed into law by Governor Wilson in September 1992.

Reasons for the repeal focused primarily on issues relating to the operational and structural design of the CRER Program. The original Act included no enforcement provisions to ensure that homeowners would pay surcharges and that insurance companies would comply with various requirements. This created an unstable and unpredictable revenue base for the Fund and a difficult program management environment for the Department. Difficulties in getting insurers to submit surcharge revenue and properly formatted data early on, and the associated problem of determining who was eligible for program benefits, though not direct causes for repeal, presented additional operational burdens for the program. Finally, while the Act explicitly limited the state's liability for benefits which the CRER Fund could not pay, many still feared the program unnecessarily placed the General Fund at risk.

In addition to terminating the program's benefits on January 1, 1993, repeal legislation contained the following additional provisions:

- All valid claims arising before the effective date of program repeal would be paid in the same manner claims previous to the appeal legislation were paid.

- Appropriated Fund money to terminate program operations and pay for administrative services and contract services.
- Any remaining balance after operation and termination expenses are paid would be refunded on a pro rata basis to those who paid into the Fund.
- The General Fund would be free of any liability for:
  - the costs of program administration
  - reinsurance
  - contract services
  - future costs associated with termination.
- The state would not be liable for claims which exceed the amount of money in the Fund at the time of termination.
- Insurance companies which had collected surcharges would not bear any financial liability for benefit payments made by the Fund or for any pro rata refund distributions made to policyholders.
- The program's Advisory Committee would report to the Legislature on issues related to existing coverage for earthquake damage and the feasibility of establishing another recovery fund in the future.
- A fiscal and management audit of the CRER Fund and its termination would be conducted by the Auditor General. This report has been prepared pursuant to this requirement.

Program Termination And Related Activities

During the one year that the program was in operation:

- Surcharges were received from approximately 4.6 of an estimated 6.7 million homeowners
- Surcharges were collected by 133 insurance companies

- Approximately $235 million in surcharges were deposited to the Fund
- Approximately 14,000 claims were processed
- Approximately 8,500 claims were approved
- Approximately $53 million in claims were paid.

Almost all claims submitted have been settled, and the Department has sent out pro rata refund checks to homeowners for the money remaining in the Fund (excluding reserves for anticipated final costs). Refunds have totalled about $130 million. This includes the initial pro rata refund, which totaled $125 million and subsequent refunds which totaled nearly $5 million. The current schedule developed by DOI staff calls for the program to cease all administrative activities related to the Act by March 31, 1994.

The CRER Program has been the subject of several audits since its repeal was announced. The State Controller's Office conducted three audits. The first was published in September 1993 and verifies that during the period of CRER Program operations between May and December 1992, the Fund's payment system was "...adequate to ensure that financial payments made were accurate, legal and proper." Next, the SCO reviewed the Fund's operations as a part of their broader audit of the California Department of Insurance's internal control structure. This audit has been completed, but the report is still in draft form. The third SCO audit evaluated the Fund's electronic data processing (EDP) controls as developed and operated by the contractor, CSC. This EDP audit is complete but also is still in the draft report stage.

In addition to the SCO audits, the Department is using the services of two private firms to assist in its pending contract dispute with CSC.

On May 3, 1993, R & G Associates contracted to assist the DOI in reviewing CSC's services. On October 22, 1993, R & G Associates was issued a second contract to provide additional CRER Program-related services, as well as other non-program services for the Department. This contract is ongoing as of this date of our report.

In late November/early December 1993, DOI began using the services of Orrick, Herrington & Sutcliffe (OHS) for legal support in relation to the same contractual dispute with CSC. More information is provided in Chapter 3 on the issues and allegations

related to the contract dispute between DOI and CSC. OHS was selected to provide these services because of their knowledge of the program, i.e., during the implementation phase of the program, OHS assisted the Department in developing regulations. On August 16, 1991, OHS was issued a $60,000 contract for these initial services.

Scope & Methodology

The overall goal of this audit was to assess the performance of the Department in implementing, administering and planning for the termination of the California Residential Earthquake Recovery Program. This review was conducted to address the audit requirements identified in Assembly Bill 2049. The work included the following significant objectives:

- Determination of whether the the Department established the required regulations, rules, systems, policies and procedures to implement the Act, including:
  - adjustment of claims
  - appeal of the determination of the claims adjustment process
  - collection of surcharges from insurance companies
  - oversight of insurance company administrative charges
  - development of management information systems
  - tracking and allocation of direct and indirect costs.
- Evaluation of the efficiency and effectiveness of claims processing, including:
  - determination of the number and amount of claims paid during the life of the program
  - determination of the whether claims paid against the fund were appropriate and in accordance with the provisions of the program.
- Evaluation of the termination of the program including:
  - determination of the amount of funds deemed available and the amount actually available for termination costs

- determination of whether moneys in the fund were used only for program termination costs, including administrative expenses and payments for contract services

- validation of the amount of funds available in the fund for rebate

- validation of the calculation of the amount of refunds on a pro rata basis

- determination of the amount of liabilities, to date, remaining in the fund

- determination of any unfunded liability relating to the program.

Interviews Initially, audit efforts focused on interviewing CRER Program executives and management, and collecting and reviewing relevant background information in order to develop an overall understanding of the program in terms of:

- Statutes, rules, and regulations governing the program

- Policies, plans, and procedures governing the implementation, administration, and termination of the program

- Legislative reports related to the program

- Number, composition, and organization of staffing resources

- Organization and flow of work

- Claims filing, processing, and payment procedures

- Claims filing systems, and contents of these files

- Methods for capturing and allocating direct and indirect costs

- Services provided by Computer Sciences Corporation

- The Department's data and information support system capabilities.

We collected and reviewed available background information in each of these areas, and then scheduled and conducted a series of interviews. The majority of our interviews were conducted with the current management and staff of the program who have directed the termination efforts during the past fourteen months. Currently, the program is in the late stages of the termination process, and only a small number of personnel involved with its start-up and operation are available for consultation. In many cases, the managers and staff responsible for specific functions are no longer employed by the Department of Insurance.

In addition to our interviews with current program management and staff, we conducted an interview with representatives from CSC, including the Manager of the CRER project. However, because the Department's contract with CSC was terminated in May 1993, our access to CSC was limited.

We also reviewed reports and pertinent documents from the audits conducted by the State Controller's Office and R & G Associates. Further, interviews were conducted with representatives from each of these organizations to discuss their work and findings.

Analysis Of The Administrative Cost Of The Program

Various issues related to the administrative costs of the program were evaluated based upon cost information provided by the Department. This included all operating costs (salaries and benefits, services and supplies, contract expenses, etc.) incurred since program inception. The methodology employed by the Department for capturing and allocating direct and indirect costs was reviewed as to whether appropriate techniques and relevant statistics were used to account for and distribute costs.

The budget for the Earthquake Program also was reviewed. Budgeted expenditures were compared to actual expenditures to determine if significant variances occurred. In addition, budgeted and actual staffing levels were examined. Due to the size and complexity of the CSC contract, expenditures for CSC's services were identified and contract monitoring procedures were reviewed.

Using information provided by the Department, the administrative cost per policy holder was determined. However, because of the unique nature of this program, it was not reasonable to compare this amount to the administrative costs for other types of benefit programs or insurance providers.

Review Of A Sample Of Claims Filed And Paid

A detailed analysis of the claims process was performed on a random sample of 430 claims chosen from the 14,000 or so total claims filed. The files were reviewed to determine if each claim had been processed in an accurate and timely manner. Each file was examined for over forty separate documents and procedures. In particular, our review focused on whether:

- An acknowledgment letter was sent to the claimant
- The claimant's insurance carrier was identified
- The claimant's fire insurance coverage amount was documented
- The claimant was covered by private earthquake insurance and, if so, the amount of the deductible
- The eligibility status of the claimant was documented
- An eligibility status notification letter was sent to the claimant
- An on-site inspection of the property was made
- An adjuster report detailing the loss estimate was prepared
- A review of the adjuster's loss estimate was conducted
- An appropriate decision for claim approval or denial was made
- The approved claims did not exceed the maximum limit of $15,000 or the amount of private earthquake insurance if less than $15,000
- The approved claims were reduced by the correct CRER Fund deductible
- A supervisor reviewed the complete file
- A decision letter explaining claim approval or denial was sent to the claimant
- The date and outcome of an appeal was documented, if appropriate.

This information was entered into an automated database and was used to help evaluate the efficiency and effectiveness of the claims process.

Evaluation Of The Effectiveness Of The Claims Process

The claims process employed by the Department was assessed for reasonableness and conformance with industry practices. The effectiveness of the claims process was evaluated as to the time required to process and pay claims. In addition, the following measures of claims processing effectiveness were evaluated:

- Claims were paid in accordance with CRER Program criteria
- Required documents were prepared correctly and approved by appropriate personnel
- Additional CRER Program procedures for processing and payment of claims were followed.

Discrepancies with CRER Program policies and procedures were documented and discussed with program management. The evaluation of the claims process concluded with an indication as to whether the procedures were appropriate and were followed for the 430 claims chosen in the random sample.

Review Of Insurance Company Requirements

An evaluation was performed as to whether the administration fee charged by insurers to insureds during the one operating year of the program exceeded the maximum limit of one dollar. This evaluation involved reviewing a sample of billing statements and additional documentation on file with the program. We also investigated whether payments of the surcharge by insurers to the State Treasurer were made within 30 days of the end of the quarter in which the surcharge was collected.

We conducted an evaluation of the process followed by insurance companies to submit data to the Earthquake Recovery Program. We reviewed available documents related to the timeliness and accuracy of data submissions, and examined the impact data transfer and data processing had on the overall operation of the program.

Analysis Of Fund Disbursements And Liabilities

An accounting of Fund disbursements was prepared from program records. The amount of funds available for termination of the program then was determined. In addition, the Department's projections of remaining fund liabilities were reviewed and compared to outstanding claims, executed contracts, and other information related to Fund liabilities.

Chapter 1 Despite The Lack Of Enforcement Authority And Program Stability, The Department Accomplished The Fundamental Purpose Of The Legislation

Chapter Summary

Information on deficiencies in the structure of the CRER Program as defined in the authorizing legislation, and subsequent attempts to repeal the statute, is presented in this chapter. Other complicating factors or problems affecting implementation and operation of the program also are described, as well as the resulting management and operational environment. This overview is important to understanding why certain developments took place, as discussed in subsequent chapters of this report. In fact, there are frequent references to other chapters for details supporting the findings presented here.

Our overall conclusion regarding the Department's management of the CRER Program, which is presented in this chapter, is that the *essential* purpose of the program was fulfilled. The Department completed the basic functions necessary to ensure that claim payments were made and funds were controlled. Given the unusual circumstances surrounding this program, this is a noteworthy accomplishment. However, the Department's performance in specific aspects of the implementation, operation, and termination of the program lacked consistency and/or effectiveness, albeit sometimes for reasons beyond its control.

Background

As stated in the preceding "Introduction," SB 2902 established the CRER Program and set forth its primary operating requirements in some ten pages of statutory detail. The basic intent of the legislation, however, can be paraphrased as follows: *To provide payments to residential property owners for structural damage caused by earthquakes.* This basic purpose incorporated explicit limitations on the use of the money collected from property owners to support the program (e.g., to be used only for claims adjusting, property damage, program administration and operation, purchase of reinsurance, etc.). The legislation also placed various other requirements on the Insurance Commissioner and the Department of Insurance, including the need to adopt administrative regulations containing detailed program procedures. Additionally, the Department's general management responsibilities include effective and efficient use of any funds entrusted to it, including

the CRER Fund. While this statement may be somewhat axiomatic, it nevertheless provides a rationale for why some decisions were made by the DOI, particularly with respect to program staffing.

Exhibit I, following this page, illustrates the timing and time/event relationships of the more important events affecting the CRER Program.

The Department Accomplished The Basic Purpose Of The Legislation

This report documents various strengths and weaknesses in the program's structural design and the subsequent development, management, operation, and termination of the CRER Program. Nevertheless, the overall conclusion is that, because of the strengths and despite the weaknesses, the essential purpose of the program was fulfilled in that:

- California residential property owners filed claims and, when eligible, received payments for earthquake damages consistent with the statutory limitations
- Claims were paid accurately and in accordance with adjusters' findings, based upon our sample review of claim files
- The program has been funded through policy holder surcharges, i.e., no General Fund expenditures of consequence
- To our knowledge, there is no residual negative public or insurance industry reaction of consequence.

In summary, the Department completed the basic functions necessary to ensure that payments were made and funds were controlled. Given the unusual circumstances surrounding this program, this is a significant accomplishment.

The CRER Program Was Developed And Operated Within An Unusually Difficult And Unstable Environment

The circumstances surrounding the Department's development and one-year operation of the CRER Program were very unusual -- if not unique -- among major new programs initiated by the state. These extenuating circumstances should be considered when evaluating the program management and operation. Key issues in this regard are summarized below:

Summary Schedule Of Significant Events Influencing CRER Program Management And Operation

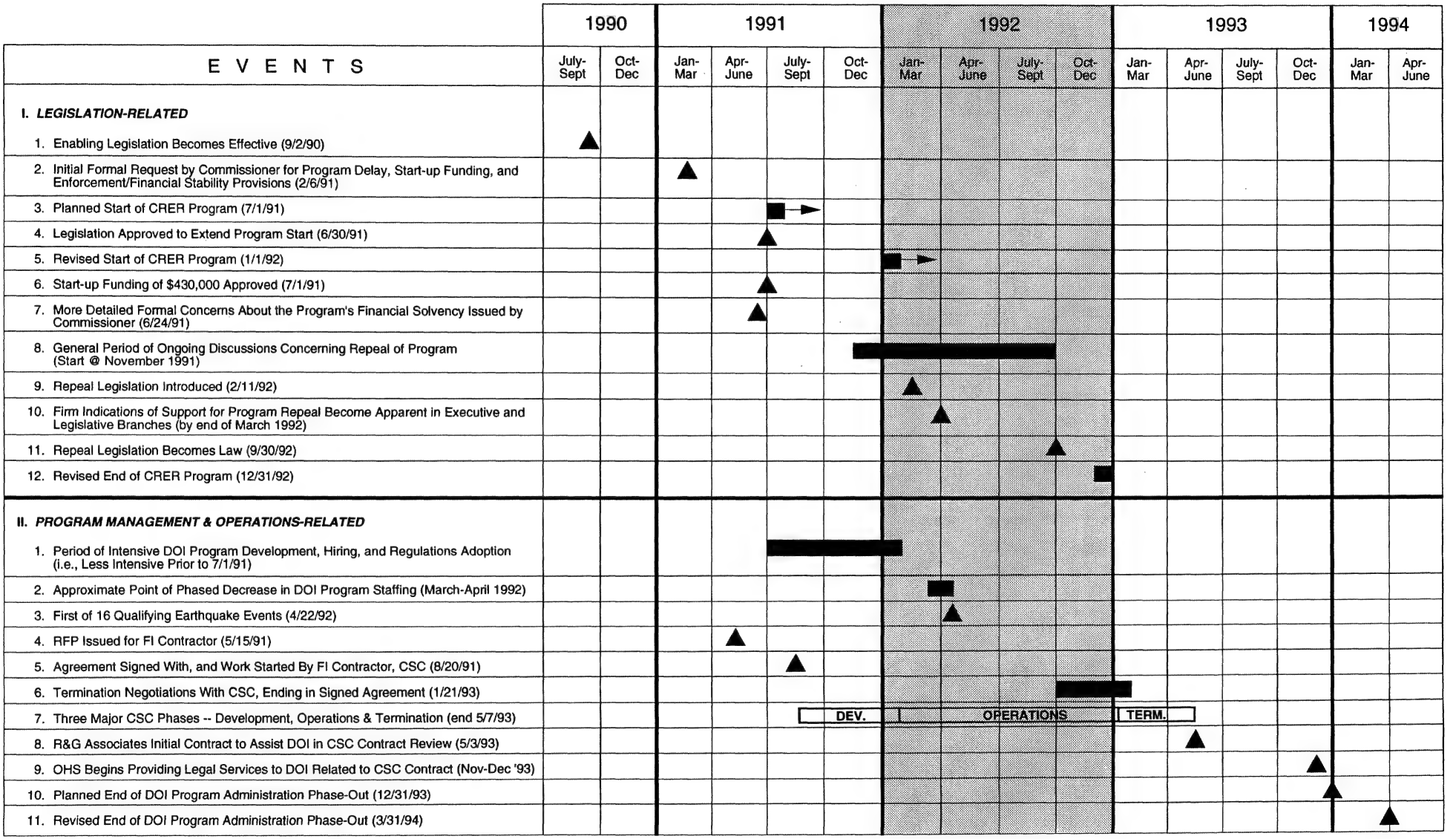

EXHIBIT I

1. The enabling legislation contained no provisions for enforcing the surcharge payments or other functions assigned to insurance companies and/or property owners. As pointed out in Chapters 2 and 4, this major program weakness contributed to delays, errors, and refusals to comply that affected surcharge collections and claims processing. Repeated requests by the Commissioner -- starting as early as February 1991 -- to amend the statutes to provide appropriate enforcement powers were unsuccessful.

2. Open discussion of the potential repeal of the CRER Program began about two months **before** it started operations on January 1, 1992. Furthermore, by early February 1992 -- about six weeks after it started -- specific repeal legislation in the form of AB 2049 (Isenberg) was introduced. This bill included an urgency clause that would allow repeal to occur immediately upon final approval of the legislation. Within another six weeks or so, it became clear that repeal was a strong probability, if not an eventual certainty (e.g., the bill was sent to the full Senate after a 7 to 1 favorable vote by the Senate Appropriations Committee, and the Governor stated his willingness to sign the legislation). Actually, by late March 1992 there was very good reason for DOI management to believe the entire program would be shut down by some time in April 1992. These repeal-related events and understandings played an important role in the Department's program staffing decisions, as discussed in Chapters 3 and 6. They also undoubtedly affected the extent of voluntary program compliance achieved with some insurance companies and property owners.

3. There was a change in DOI administration on January 1, 1991 which resulted from California's first election of an Insurance Commissioner in November 1990. Significant efforts to develop the program were delayed until Commissioner Garamendi took office. Additionally, the enabling legislation provided no start-up funding for the substantial planning and developmental work involved. Despite formal requests for such funding as early as February 6, 1991, it was not forthcoming until $430,000 was authorized nearly five months later. The combination of the change in Commissioners and the lack of early start-up funding necessitated a delay of six months in the planned start of the program, i.e., from July 1, 1991 to January 1, 1992. We believe these are reasonable causes for the implementation delay.

4. The Department's ability to hire and retain skilled specialists and other necessary program staff was constrained due to substantial uncertainty regarding long-term job security. This was a concern early on, but not a severe one. Once the repeal legislation was introduced, the problem was exacerbated. This factor influenced the Department's decision-making regarding when and how it attempted to fill authorized program positions.

5. Selection of a FI contractor was essentially limited to CSC, which was the only firm that bid the full range of services described in the Department's RFP.

The foregoing summary portrays what we believe is an unusual and difficult environment in which an important, very visible new program had to be implemented successfully. These factors do not fully explain or rationalize deficiencies in program management and operation that are described in subsequent chapters. They are, however, extenuating circumstances.

The Uncertain Environment Influenced The DOI To Focus Substantially On Critical Path Tasks

The aura of uncertainty, probable repeal, enforcement limitations, and limited FI contracting options caused the DOI program personnel to focus primarily on completing critical tasks. These were tasks that were essential to:

- Establishing a basic, functioning information system
- Processing claims
- Making accurate, justified payments to eligible claimants.

Under any circumstances, priority would normally be given to these types of critical tasks. The point here, however, is that the focus on critical activities seems to have been proportionately greater in the CRER Program because of all the extenuating circumstances just described. Other tasks, including close inspection and monitoring of a multi-million dollar FI contract, did not receive the staffing resources warranted (and that they may have received under more stable conditions).

Conclusion

The basic intent of the CRER program was to provide payments to residential property owners for structural damage caused by earthquakes. Our overall conclusion is that the Department fulfilled the essential purpose of the program in that surcharge payments were collected and claims were processed accurately. Given the unusual circumstances surrounding this program, this is a significant accomplishment.

The environment in which the program was developed was unusually difficult and unstable. These extenuating circumstances include the lack of enforcement provisions for the collection of surcharges, open discussions of the potential repeal of the program before it started operations, a change in DOI administration, constraints on the Department's ability hire and retain staff, and limited FI contracting options. Although these extenuating circumstances clearly impacted the Department's decision-making related to administration and operation of the program, they do not fully explain or rationalize the deficiencies in program management and operation that are identified in this report.

Chapter 2 The Surcharge Collection Process Was Unduly Complex, Primarily For Reasons Beyond The Department's Control

Chapter Summary

This chapter presents various findings related to the collection and refunding of surcharges. Legislative and regulatory issues are discussed, as are technical problems encountered in collecting surcharge data. In addition, findings related to the Department's implementation of surcharge-related regulations and policies are described.

The findings included in this chapter indicate that the surcharge collection process was inefficient and unduly complex. However, problems related to surcharge collections were primarily structural in nature and, for the most part, beyond the Department's control. In particular, lack of enforcement provisions in the authorizing legislation left the program with an unpredictable and unstable source of funding. This fundamental weakness also contributed to various data collection problems related to policy holder information which, in turn, resulted in the less-than-planned effectiveness of the CRER Information System.

Background

The legislation authorizing the CRER Program required that insurance companies collect the program surcharge as part of the their residential property insurance billing process. Specifically, §5003(a) of the Insurance Code states, "Every insured shall at the time of paying the premium for the policy of residential property insurance on property located within the state, pay the earthquake surcharge established by the commissioner." This method of utilizing insurance companies to collect surcharges for a state administered benefits program had not been used for any other program.

A total of 133 insurance companies were required to bill the CRER surcharge on residential policies and remit the funds collected to the State Treasurer. A copy of the transmittal letter accompanying the payment, along with policyholder and property data, was sent directly to the Department's fiscal intermediary, CSC. CSC was responsible for updating data records (policyholder name, billing address, property address, description, insurance company, etc.) and for reconciling surcharge payment information with monies remitted to the State Treasurer. Data was submitted to CSC in several formats, ranging from paper reports to magnetic tape.

Program Implementation Required Development Of A Special Surcharge Reporting Process Within All Affected Insurance Companies

Prior to the CRER Program, insurance companies were not required to provide detailed policy holder information to the state or any other governmental agency. Accordingly, insurance company policy holder databases were designed to meet only the specific needs of each company. While each company's database contained the same basic information, the way this data was organized varied significantly. In order to comply with the mandate of collecting surcharges and transmitting policy holder information to the state, insurers generally had to reprogram their billing systems and reconfigure their policy data to conform with the program's submission format. For some insurance companies, the process of modifying databases and billing systems was not too difficult. For others, it was both time consuming and costly.

Although they may have attempted to provide policy holder data in a consistent, approved format to comply with these requirements, many companies provided data which did not pass the system edits. Data submissions that were incorrect, incomplete, or could not be processed due to format errors were either held in "suspense" or rejected outright and returned to the companies for correction. In these circumstances, insurance companies had to spend time correcting the errors, and CSC had to process the information more than once before it could be posted to the system.

Many of the problems experienced by insurance companies in implementing the surcharge collection process contributed to the findings presented in this chapter.

The Lack Of Enforcement Provisions Created Major Problems Related To Surcharge Collections And Insurance Company Participation

Although the program's authorizing legislation required residential property owners to pay the earthquake surcharge, it did not provide any penalties if they refused. The program regulations further verify that there were no penalties for failing to pay the surcharge. Specifically, §2698.21 of the Regulations includes the following comments:

"(a) Claimants who fail to meet their surcharge obligations when billed under the Act and the Regulations shall be ineligible to receive payments.

(b) Failure to pay, collect or remit the surcharge shall not affect the validity of enforceability of any residential property insurance then in effect or the covered owner's or insurer's obligations under such policy."

Because there were no penalties for failing to pay the surcharge, many residential property owners did not participate in the program. Based upon information provided by CRER management, approximately 6.7 million property owners were eligible to participate in the program; however, only 4.6 million property owners paid the surcharge during the program's one year of operation.

Because the program did not have enforcement provisions for homeowners, it was difficult to determine the amount of surcharge revenue that would be collected over a given period of time. This lack of a predictable revenue stream limited the program's ability to purchase reinsurance and issue revenue bonds.

The authorizing legislation also required insurance companies to collect the surcharge when homeowners were billed for their residential property insurance. In addition, companies were supposed to transmit the collected surcharges on a monthly basis. However, the legislation did not provide any specific enforcement mechanisms if insurance companies did not comply with these requirements.

Due to the combination of technical difficulties experienced by various companies in implementing the surcharge billing process and the lack of enforcement provisions, many companies did not bill for the surcharge or submit data in a timely fashion. Additionally, when surcharge data was transmitted to the Department and found to have an unacceptable number of errors, enforcement provisions were not available to ensure that corrections were made in a timely manner.

Although the Department could utilize other approaches to encourage insurance companies to comply with program requirements, such as conducting audits or potentially suggesting legal action, these options were time consuming and costly, and not considered practical under the circumstances. For example, the Department's legal options admittedly were very limited and dealt mainly with laws affecting companies that:

- Were in arrears on money accrued during their business and owed to the state (but not applicable apparently to a refusal to collect a fee)

- Were in danger of becoming insolvent or otherwise operating hazardly or illegally.

The applicability of these two statutes to remedy the surcharge collection problem was, at a minimum, questionable.

Late And Non-Compliant Insurers Reduced Claims Processing Efficiency

The CRERF Information System was designed to track policy holder information and provide immediate verification of eligibility when claims were submitted. However, incomplete and incorrect policy holder information submitted by insurers limited the system's ability to verify eligibility. If claimant eligibility could not be verified based on information available in the system, CSC had to contact the claimant's insurance company to verify eligibility. This increased CSC's claims processing work, and contributed to the need for a change order which totaled $817,737. If the insurance companies had submitted correct policy holder data in a timely manner, this change order might not have been required.

The Department's Temporary Discontinuance Of Processing Surcharge Data Also Reduced Claims Processing Efficiency

As noted previously, the primary reason that the CRERF Information System could not always be used to verify claimant eligibility was because policy holder information was not accurately submitted in a timely fashion. However, during the Spring of 1992, the Department instructed CSC to stop processing surcharge data from April 8, 1992 until June 12, 1992 for two reasons:

- At the time, there was reason to believe the program's repeal was imminent. Consequently, DOI management wanted to minimize expenditures for FI services

- The initial high volume of policy holder data had not been anticipated. Because CSC was paid on a per-transaction basis for each system posting of policy holder data, the Department was concerned about actual expenditures exceeding the program's budget for FY 1991/92.

During this period, insurance companies continued to bill policyholders and remit surcharge premiums to the State Treasurer, and forward data records to CSC. However, because these records were not loaded into the system, CSC could not access this information when attempting to verify claimant eligibility. This increased CSC's work load and contributed to the contractor's request for the $817,737 change order mentioned previously.

Many Insurers Did Not Fully Comply With Monthly Submission And/Or Surcharge Collector Requirements

Few insurers complied with the requirement to submit surcharges, interest and policy data within 30 days from the end of the month in which the surcharge was collected. CRER Program management was unable to provide definitive reports which tracked monthly submissions; however, a CSC summary report suggests that 98 of 132 companies -- nearly 75 percent -- waited until the second half of 1992 before making any surcharge or policy submissions. As of June 30, 1992, only $38,227,000 (about 16 percent) of about $236 million total surcharge revenue for the calendar year had been received from insurance companies. According to program management, some insurers submitted all money and information for several different months at the same time, and others delayed their submissions due to back billing (i.e., issuing a second bill for only the surcharge after a policy holder had paid a first bill for only the insurance premium).

Efforts were made to enforce surcharge and data submission policies, but they met with limited success. The best enforcement measure available to the program was legal action, as described previously, but even this was weak. Eight companies were formally referred to the Department's Legal Unit after the program's final deadline for submitting surcharge deposits and policy data had passed. The Department also was granted authority under §2698.17 of the Regulations to audit companies for non-compliance. Two such audits were conducted in the fall of 1992. The audited companies were selected on the basis of their market share in the industry and their history of delays in cooperating with the program.

At the end of their contract with the program, CSC reported that 88 of all 133 participating companies, or 66 percent, had submitted acceptable policy data and remitted the corresponding surcharge deposits. Of the remaining 34 percent of companies, 23 had problems meeting the technical requirements for transmitting data and still needed to correct errors in their submissions. The remaining 22 (about 17 percent) were deemed non-compliant since they demonstrated a history of ignoring program policies and requests. This last group included insurers who sent in:

- Surcharge deposits, but no policy data (which the Department refers to as "Cash-No Data")

- Policy data, but no surcharge deposits

- All surcharge deposits and policy data in one submission which contained an unacceptable number of errors and had not been corrected

- Partial surcharge deposits and policy data, with no attempts to remit the rest

- No deposits or policy data during the life of the program.

Resolution of these problems, which were called "residuals", has been incorporated into the Fund's termination activities.

The Department Did Not Properly Instruct Insurers On How To Bill The Surcharge And Administrative Fee

Section 5003 of the Insurance Code and §2698.2(a)1 of the program Regulations clearly state that the surcharge and administrative fee, when charged, must each be listed separately on billing statements. Six of the twelve insurance company files we reviewed included documentation requested by the Department which showed that the surcharge was itemized separately on billing statements. The other six had no information of this type. Program management indicated that a check on company compliance should have been performed by CSC staff, but could not provide evidence that it had occurred.

The degree to which companies complied with this requirement may have been influenced by information in the *Surcharge and Policy Submission Guidelines* distributed to insurers by the Department in October 1991. Page 37 of the *Guidelines* states, "DOI does not require the billing of the surcharge to be out on a separate line." A separate letter sent out under the Commissioner's signature on October 30, 1991 read, "The Department does not specify how the surcharge and administrative fee are to be reported on insurer billing notices, leaving this procedure to the discretion of individual insurance companies, in recognition of the different types of insurer billing systems." These references are in conflict with the Code and Regulations. Fund personnel could not explain why these instructions were sent to insurers and suggested that the interpretation was unclear, but not necessarily contrary to the program's legal requirements.

Interest Earned By Insurers On Surcharge Deposits Was Not Monitored And Sometimes Was Not Collected

Insurance companies were required to keep surcharge monies in interest-bearing accounts and to remit to the State Treasurer all interest these accounts earned. Interest was recorded when it was submitted along with insurers' surcharge deposits, but the amounts remitted were not evaluated in terms of the relationships between interest amounts and surcharge revenue deposited.

Although interest payments were not monitored, we did not find evidence of widespread abuse of the program's interest provisions by the insurance industry. If we assume that surcharge revenue was held by insurers an average of 15 days, then the amount of interest the Department received seems reasonable, i.e., $509,411 in interest on $207,409,851 in surcharge deposits over the life of the program. This would equate to approximately a 6 percent annual percentage rate (APR), again assuming a 15-day average deposit length. The approximate APR would be about 3 percent if the average deposit length was 30 days.

A brief review of CSC reports show that approximately 22 to 26 percent (15 of 57 companies in FY1991/92 and 25 of 113 companies in FY1992/93) of all companies submitting surcharge deposits did not submit corresponding interest in any amount for one or more months. Program management indicated that interest receivables were not monitored since it was difficult to determine when companies actually received surcharge payments. Management also assumed the Department's Examination Unit would determine if interest due the Fund was actually paid when companies were audited for compliance.

Policyholder Payment Incentives To Participate In The Program Were Reduced

The insurance companies' practice of retroactively billing policy holders for the surcharge lowered the number of residents who participated in the program. Many companies were not ready to bill the surcharge at the start of 1992 when their newly issued and renewal policy premiums were due. Rather than delaying their normal premium bills, the companies chose to send out statements which did not include the surcharge and then later billed those same policy holders a second time, or retroactively, for just the surcharge. Policyholders who believed they had already paid the full amount of their insurance premium when first billed were more likely to disregard this second bill and not pay the surcharge.

Another factor affecting policy holder participation was the introduction in February 1992, and passage seven months later in September, of legislation repealing the CRER Program. A policy holder's incentive to pay the surcharge was greatly reduced if he/she learned the program was likely to be or was in fact terminated.

Lack Of Program Participation Reduced The Amount Available For Pro Rata Refunds

As noted previously, approximately 4.6 million of the estimated 6.7 million eligible program participants actually paid the surcharge during the program's one year of operation. This is a 69 percent participation rate. Because a limited number of homeowners participated in the program, the loss risk was spread over a smaller group of homeowners. If the program had achieved somewhere near a 100 percent participation rate, the claims payments and administrative costs would have been shared by an increased number of homeowners and the amount of the pro rata refund would have been greater. This statement assumes that there would have been some increase in program administrative costs related to the 2.1 additional participants, but no appreciable increase in claims payments. The latter assumption arises out of the unique "grandfather" provision of the program whereby property owners could file claims after an earthquake even if they had not paid the surcharge. If such a claim was approved, the surcharge amount then was deducted from the payment. Under these generous conditions, it seems reasonable to conclude that all or nearly all valid 1992 claims probably were filed, and that few, if any, of the 2.1 million non-participants suffered eligible earthquake damage without submitting a claim.

Based on the assumptions outlined in **Exhibit II**, following this page, the pro rata refund percentage might have been 67.5 percent or so instead of 56.9 percent, if all eligible homeowners had paid the surcharge. The average pro rata refund for each program participant, therefore, might have increased by $6 to about $35, rather than the $29 actually paid. Because of the substantial number of homeowners who did not pay the surcharge, those who did participate had to bear a higher individual percentage of the program administrative and claims expenses.

EXHIBIT II

Estimated Pro Rata Refund Amount With 100 Percent Program Participation

Summary of Program Participation	
Estimated Number of Homeowners Eligible for Program Benefits	6,700,000
Actual Number of Homeowners Who Paid the Surcharge	4,600,000
Homeowners Who Did Not Pay the Surcharge	2,100,000
Actual Program Results	
Total Surcharge Revenue Collected	$ 236,000,000
Program Expenses and Reserves	$ 111,000,000
Amount Available for Pro Rata Refunds	$ 125,000,000
Pro Rata Refund Percentage	56.9%
Average Surcharge Amount	$ 51
Average Pro Rata Refund Amount--69 Percent Participation	$ 29
Program Results With 100 Percent Participation (Hypothetical)	
Surcharge Revenue Collected From 4.6 Million Homeowners	$ 236,000,000
Surcharge Revenue Collected From An Additional 2.1 Million Homeowners ($51.30 per Policy)	$ 107,730,000
Estimated Total Surcharge Revenue	$ 343,730,000
Program Expenses and Reserves	$ 111,000,000
Additional Surcharge Processing Expense[a/]	$ 630,000
Amount Available for Pro Rata Refunds	$ 232,100,000
Pro Rate Refund Percentage	67.5%
Average Surcharge Amount	$ 51
Average Pro Rata Refund Amount--100 Percent Participation	$ 35

a/ The contract with CSC included price reductions as the number of policies processed increased. If an additional 2.1 million policy holders had participated in the program, the administrative cost per policy would have been approximately $0.30, for a total of $630,000 in program expenses. Other program expenses should not have been impacted significantly by a 100 participation rate.

Conclusion

The lack of adequate enforcement provisions in the CRER Program's authorizing legislation presented a number of challenges and problems related to implementation. Some insurance companies refused to participate or, at a minimum, provided less than satisfactory compliance with DOI requests. Requirements related to monthly submission of surcharge revenue, interest, and policy holder data sometimes were ignored or not properly fulfilled by insurers. The insurance companies also had to redesign automated systems to accommodate the new governmental surcharge collection and data reporting requirements. This work often was costly and, in many instances, resulted in late, incorrect, and/or improperly formatted data submissions to CSC. In turn, these problems contributed to the general inefficiencies associated with the surcharge collection process and the less-than-planned effectiveness of the CRER Information System.

The Department did not monitor the interest earned by insurance companies, nor did it properly instruct them on how to bill the surcharge and administrative fee. Its suspension of all processing of surcharge and policy holder data for over two months, although understandable, contributed to inefficiencies affecting the surcharge and data processing operations.

Although the program's authorizing legislation indicated that all eligible homeowners had to participate, there were no penalties for lack of participation except that program benefits would be withheld. This lack of enforcement resulted in only 69 percent of eligible homeowners participating in the program. Accordingly, the risk and administrative costs of the program were unfairly spread among this smaller group.

Chapter 3 The Department Did Not Adequately Perform Its Contract Management Functions

Chapter Summary

This chapter deals with the contract administration and oversight responsibilities of the Department, with emphasis on DOI's management of its primary contractor, Computer Sciences Corporation. Issues related to staffing and performing the program's contract management function are discussed, as well as the Department's oversight of CSC's efforts to develop the CRERF Information System and to process claims. The findings in this section are based on a review of contracts, invoices and selected contractor deliverables, plus discussions with program personnel and the staff of several contractors.

The most significant deficiency identified during this evaluation was that the Department did not adequately perform its contract management functions. A five-year, $66 million contract was issued to Computer Sciences Corporation to design and implement the CRER Information System, and to provide fiscal intermediary and claims adjustment services. Based upon our review, it does not appear that the Department (1) effectively monitored contractor performance and charges, (2) ensured that contractual requirements were met before major invoices were paid, and (3) established reasonable performance criteria for payment of termination services. These issues are particularly important because the majority of the program's implementation, operation and termination activities were conducted by CSC.

Background

Because of the size and complexity of the program, the Department decided to utilize the services of outside contractors to implement and administer the collection of policy holder and surcharge information, and to process claims. Department personnel were to manage the overall program and monitor the work of contractors.

On May 15, 1991, the Department of Insurance issued Request for Proposals (RFP) DOI 91-02. This RFP solicited the services of one or two organizations to assist with program implementation. The RFP contained two components:

- *Fiscal Intermediary (FI) Services* -- The firm selected to provide FI services would be responsible for collecting policy holder and surcharge payment information, fund balance accounting,

verifying claimant eligibility, tracking claims payment information, and conducting actuarial analysis. All of these activities were to be conducted using the CRERF Information System, which was to be developed by the FI contractor during the initial contract phase.

- *Claims Adjustment Firm (CAF) Services* -- The CAF contractor would be responsible for accepting claims, verifying claimant's program eligibility with the FI contractor, determining the amount of loss incurred by each claimant, and recommending a payment amount for each claim. In addition, the CAF contractor was to process first level claim appeals and support the Department's processing of second level claim appeals.

The RFP indicated that potential vendors could bid on one or both of the services described above.

The Department received a proposal from Computer Sciences Corporation to provide both FI and CAF services. Another firm submitted a proposal to provide CAF services only. These were the only responses to the RFP. Because of the strong link between the two project components and the anticipated efficiencies resulting from having the same prime contractor provide both services, CSC was selected to provide both FI and CAF services.

On August 20, 1991, the Department entered into an agreement with CSC. The total amount of the contract was $66,310,380, which included the development of the CRERF Information System and five years of FI and CAF services. The cost to develop the information system was $4.3 million, and FI/CAF services averaged a little more than $12 million per year.

Due to the early termination of the program, CSC's services were only required for approximately twenty months. This included four months of program development, twelve months for program operations, and four months of termination activities. CSC's billings totaled nearly $33 million during this twenty-month period, broken down generally as shown in **Table 3.1**, on the following page.

Table 3.1
Approximate CSC Billings
By Major Service Category

	In Millions
Development of the CRERF Information System	$ 4.7
FI Services	13.0
CAF Services	10.5
Termination Activities	4.4
Approximate Total	$ 32.6

The Department also has used two other contractors in the CRER Program, supported by payments from the CRER Fund.

- R & G Associates was employed initially on May 3, 1993 to provide specialized assistance in the review of CSC's contract activities, particularly the termination phase work. Since May 1993, two additional contracts have been awarded to R & G by the Department, primarily for support in its current contract dispute with CSC.

- Orrick, Herrington & Sutcliffe, a law firm, was employed on August 16, 1991 to assist the DOI in writing the program's administrative regulations. More recently (late November - early December 1993), OHS began providing legal services to support the CSC contract disagreements. No contract is in place for these latter services.

The Department Did Not Effectively Manage The Primary CRER Contract

Our basic finding is that the contract with CSC was not monitored and managed as one would reasonably expect when millions of dollars are at stake, nor was it managed as DOI apparently planned at the outset of the CRER Program. The fact that the fundamental purposes of the program were achieved and that there were significant extenuating circumstances -- both issues described in detail in Chapter 1 -- do not alter our view that a more effective job of contract management was warranted.

The assessment that contract management performance was not adequate in all respects is based upon several related findings, as summarized below:

- Basic contract management activities were planned but were not performed in all instances, quite probably because DOI did not commit sufficient staffing for this function

- The Department paid some CSC invoices without ensuring that all contractual requirements and sign-offs had been completed

- Various claims processing requirements applicable to CSC's operations were not monitored in all instances and/or were not enforced by DOI

- CSC's charges for transaction processing units (TPUs) -- which accounted for about $13 million in payments -- were not monitored adequately

- The termination agreement with CSC did not link deliverables or performance criteria with payments

- CSC's compliance with planned MBE/WBE participation goals was not monitored.

Each of the foregoing six statements constitutes a separate finding which, cumulatively, support the overall assessment of less than adequate contract management performance. Details supporting these six statements are provided in the remainder of this chapter, together with other incidental contract administration findings.

The Effectiveness Of The Contract Management Function Was Hampered By Insufficient Staffing

The contract management unit within the program was primarily responsible for overseeing CSC's activities. A total of five positions were budgeted for this function including the contract manager, one associated government program analyst, two staff services analysts, and an office technician. The contract management unit was **fully staffed** in the fall of 1991, and its list of assigned responsibilities included the following classic contract management functions:

- Develop management and fiscal controls for monitoring contracts

- Monitor contractor performance

- Ensure that basic contract conditions are maintained

- Review and approve all contractor performance reports and invoices for payment
- Check contractor progress against contract standards
- Submit materials and unit certifications to Fiscal Services
- Assess system-related performance of contractor
- Maintain contractor requirements data base.

In addition to the specialized contract management unit, selected personnel in other DOI program units had some contractor-related responsibilities (among other duties). Examples include the following:

- An EDP specialist in the audit unit was to review the EDP system's performance of the FI contractor
- Two associate examiners in the audit unit were to audit the CSC payment tape performance and conformance with processing standards.

The foregoing description of assigned responsibilities indicates that DOI planned for and budgeted a fairly intensive contract management function (i.e., five dedicated positions plus part-time of others for essentially one contract of significance). However, by April 1992, four of the five initial staff members had left the unit because repeal of the CRER Program appeared to be imminent. These individuals were not replaced.

When the contract management positions were vacated, it appeared that the program might be terminated at any time. The proposed repeal legislation included an urgency provision which would have eliminated the program immediately. Accordingly, the Department chose not to fill the vacancies because it did not want to hire staff for positions that may have existed for only a short period of time. Also, it is difficult to find qualified and interested candidates under these unstable employment conditions.

Given the uncertainty regarding the program's future, the decision to not fill the vacant positions with new employees may be understandable. However, given the magnitude and complexity of the CSC contract, there seems to have been good reason to staff the contract management function more adequately (although perhaps

not fully). This assessment becomes more apparent as time passes after April 1992. For example, in succeeding months the Department becomes aware that CSC is not meeting the claims processing timeframe requirements, that first year costs are far in excess of plan, and that the anticipated 5-plus year contract will likely be much shorter (thereby reducing the amount of time for long-term contract review and audit). It appears now that contract management shortcomings -- caused at least in part by insufficient staffing -- have contributed to the current dispute with CSC.

The Department Did Not Ensure That CSC Fulfilled All System-Related Requirements Before Authorizing Full Payment

The development and implementation of the CRERF Information System was a significant and costly activity. The contract described the method that would control payment for the development phase. One-half of the total **planned** cost of $4.3 million[1] was to be paid in five equal installments once the deliverables associated with these installments had been approved by the Department. The remaining 50 percent was to be paid when the following criteria had been met:

- Complete implementation of all development requirements as identified in the technical requirements section of the RFP
- Acceptance of all development deliverables by the contracting officer
- Correction of all errors/deficiencies identified during acceptance testing and verification that these corrections had been completed by the Department
- Successful operation of the system for six months.

CSC's response to the RFP identified specific deliverables, work plan steps, system requirements, and project milestones. Where deliverables are concerned, the contract requires DOI formal acceptance. More important, perhaps, the contract clearly requires completion of all "development requirements" before the final payment of over $2.1 million was made to CSC.

There are two important issues related to DOI's full payment for CSC's development phase work:

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[1] Actual total development costs were about $4.7 million. A change order approving about $400,000 in added costs was approved by the DOI, as allowed by the contract.

- First, the final payment of about $2.15 million -- made in October 1992 -- appears to have been authorized without full and effective review of CSC's performance

- Second, subsequent alleged deficiencies in the CRERF system were not identified until the termination phase. We are unable to determine if these deficiencies would have been corrected/avoided by a better review of system operating requirements (and test results) during 1992.

With regard to the first issue above, one of the key deliverables was the *User Acceptance Test Results*. This deliverable was intended to provide an overview of the system test results, highlighting any open or unresolved system performance issues. Following this deliverable, the *DOI Readiness Approval* was to be issued to CSC signifying the Department's acceptance of the system.

The Department is unable to provide the *User Acceptance Test Results* to the audit team, and cannot locate them in the 700 or so boxes of project documents delivered to DOI by CSC on May 7, 1993, at the conclusion of the CSC contract. CSC's position -- on this issue and many others related to project documentation -- is that relevant documents were included in the records delivered to DOI on May 7, 1993. It is difficult to affirm or reject this CSC assertion because the DOI did not independently inventory the records when received, nor did it check the CSC inventory against all boxes. Given the contractual dispute that had emerged by May 7th, closer inspection of any materials received from CSC would seem to have been warranted.

As for the formal *DOI Readiness Approval*, CRER program management indicated that it was never transmitted to CSC. However, management did state that Department staff members participated in the system testing and that a request to submit an invoice for final payment had been issued to CSC.

In addition to specific deliverables, DOI's systems consultant, R & G Associates, compiled a list of other technical requirements pertaining to CSC's performance in all project phases. These other "requirements" typically would not result in a formal deliverable document but, instead, would more likely produce some type of work paper, such as a computer print-out. The full list of deliverables/requirements was researched in an attempt to locate supporting documentation in the project records. Eventually, documentation or other support for 58 items either could not be found or was evaluated as deficient.

CSC was provided this list and was asked to respond to each item. The CSC responses have been received and are undergoing continuing DOI and R & G evaluation. Although many of the items are related to the termination phase and claims adjustment services, there are several non-deliverable requirements associated with the development and early FI operations phases. For example, in their proposal, CSC indicated that the Department would have a "dial-up" capability which would provide off-site access to the system. This capability was implemented only partially, according to the Department. Although it was not critical to overall operation of the system, the dial-up capability was included in the original technical specifications and is a contractual requirement.

Based on the payment provisions in the contract, the deliverables that were not provided, and the system requirements that were either not fully accomplished or are in question, the Department should not have approved the final development invoice without more complete, formal review and sign-off. The fact that the Department needed -- and CSC provided -- by early 1992 a system that performed the critical functions is not a significant extenuating factor in our view. The relevance of this factor is diminished substantially (if not entirely) by the fact that the final $2.15 million development phase payment was not made until October 1992, **after** the program had been officially repealed.

The Department Did Not Require CSC To Comply With Various Claims Processing Requirements

In Chapter 4, a number of issues concerning the claims processing function are discussed. Many of these issues are related directly to CSC's performance in its role of providing claims adjustment and FI services. Based on our sample review of 393 claim files, we concluded the following related to CSC's performance:

- The eligibility verification process was not adequately documented in the claim files
- The eligibility verification process exceeded time regulations
- The total claims processing time exceeded the maximum time limit prescribed in the Regulations in **more than half** of the files in our sample.

The contract between the Department and CSC provided for several remedies should CSC's performance be unacceptable, including the assessment of liquidated damages. When asked about these issues,

CRER program management indicated that they were aware that CSC was not processing claims within the timeframes required. However, remedial action was not taken because the CRERF Information System could not be used to verify claimant eligibility. This required CSC to contact insurance companies in order to verify eligibility. This step had not been anticipated and was a factor in the Department's decision to forego enforcement of the contractual timeframes.

The Department Did Not Adequately Monitor CSC's TPU Charges

Each time policy holder information was posted to the CRERF Information System, a transaction processing unit (TPU) was counted. This included the initial posting of policy holder information and surcharge payment updates. CSC billed for surcharge processing services based on the number of TPUs incurred in posting information to the system. TPUs were not earned for files that did not pass the system's edit checks.

The Department paid CSC approximately $13 million for surcharge processing activities based on the number of TPUs processed. This amount represents 54 percent of the $24 million paid to CSC during the one year of program operation (excluding the cost of developing the CRERF Information System and the cost of CSC's termination activities). While DOI did review the method used by the system to determine the number of TPUs generated, it did not verify that the TPU count was accurate when reviewing monthly invoices (e.g., reconciling the TPU count with the number of policies updated monthly).

None of the TPU reports received from CSC equated charges to actual number of records processed. These reports also did not quantify the impact that installment payments and initial data load processing had on actual TPU charges billed by CSC, and CRER management did not request a breakdown of these charges until May 1993, well after the final surcharge operations invoice had been paid. In addition, when the Department asked CSC to quantify the TPU charges associated with installment payments, CSC could not provide this information.

An additional review of the monthly TPU count was important for several reasons. TPU charges were substantially higher than expected during the program's one year of operation. This was due to the need to load policy holder information into the system at the beginning of the program. This activity originally had not been

anticipated and resulted in a TPU charge for every record entered into the system. In addition, more installment payments were received from policyholders than anticipated originally, and the processing of *each* payment in the installment plan generated an additional TPU charge.

In addition to the issues noted above, it was not possible to determine when policy holder data would be submitted and TPU charges would be generated, due to various problems experienced by insurance companies in providing this information. For example, surcharge data for billings that should have been due in January 1992 might not have been submitted to CSC for processing until April. This could have occurred because a particular insurance company had to modify its billing system to accommodate collection of the surcharge. Rejected tapes and the staggered submission of initial policy holder information also caused monthly TPU charges to vary significantly.

Program management did note that the initial system design did not envision the difficulties that were experienced in collecting surcharge revenue and data. Accordingly, the system was not designed to provide detailed TPU counts by transaction type on a monthly basis to easily support a more detailed evaluation of TPU charges. However, given the substantial cost associated with processing TPU's and the significant number of unexpected TPU's that were incurred, the Department should have required that CSC provide more detailed information regarding the TPU counts included in each monthly invoice for TPU processing services.

The Termination Agreement Did Not Link Deliverables Or Performance Criteria With Payments, Limiting The Department's Ability To Monitor CSC's Performance

On January 21, 1993, the Department and CSC signed an agreement which specified the activities that CSC would complete prior to terminating its involvement in the program. This agreement identified the following groups of activities:

- Process outstanding surcharge revenue
- Complete the review of open claims
- Work with the Department to develop the surcharge refund methodology
- Develop a Return Warrant System which would be used to issue pro rata refunds to program participants

- Transfer all fixed assets to the Department
- Transfer all records to the Department for archiving.

The cost for transferring fixed assets totaled $798,475. A fixed price of $3,606,605 was negotiated for the remaining activities, to be paid in five equal installments. Four of the five installments were to be paid based on a time schedule included in the agreement. The fifth invoice was to be submitted on the last day of the contract period and would be paid by the Department unless there were deficiencies in CSC's performance under the termination agreement.

Unlike the payment schedule for developing the CRERF Information System, payments made during the termination phase of the project were not linked to specific deliverables or performance criteria. Progress reports were required, but their contents were not specified and, in any event, would not have been technical.

The absence of effective performance criteria and contract management procedures during the termination phase seem to have contributed to the current contract dispute between DOI and CSC. DOI alleges that the Return Warrant System delivered by CSC did not function as anticipated, requiring DOI and State Controller's staff to correct various system deficiencies. Other unmet or deficient requirements are alleged in the list of 58 items developed by R & G Associates and sent to CSC for comment. The Department is withholding payment on CSC's final termination phase invoice of about $721,000, plus another invoice of approximately $66,000, and has initiated use of outside legal counsel to assist in resolving the current dispute. CSC's position is, essentially, that it has complied with all contractual requirements and has provided DOI with all relevant documentation, and now deserves to be paid. At the time this report was prepared, the contract dispute had not been resolved. More effective structure of the termination agreement and/or better contract management may have prevented or ameliorated this situation.

Some Of The Department's Rationale For Its Contract Management Approach Is Based Upon Weak Or Inconsistent Points

In Chapter 1, we discussed the key factors which resulted in a difficult, unstable environment in which the CRER Program was developed and implemented. These factors included:

1. Lack of enforcement provisions in the enabling legislation
2. Proposed repeal of the program before it started operation

3. Change in DOI administration and lack of start-up funding

4. Constrained DOI ability to hire and retain qualified program staff, especially after April 1992

5. Availability of only one bona fide proposal for FI services

6. A consequent, greater-than-normal, emphasis on critical tasks.

Certain of these factors -- particularly items, 2, 4, 5, and 6 -- are recognized as having a bearing on DOI's contract management decisions and performance. However, the Department has provided additional reasons for its actions in this area. These reasons, and our assessment of each, are summarized below.

- *Limited Time Available for System Development* -- Program implementation was delayed until January 1, 1992, but even with this delay implementation was rushed. As noted previously, the contract for FI and CAF services was not approved until mid-August 1991. This meant that the CRERF Information System had to be designed, developed, tested, and implemented in approximately four months. Because this system had to accept information from over 130 insurance companies, the development process would be complex under any circumstances. However, CRER management told us that because of the limited time available to develop the system, both CSC and the Department concentrated on critical system elements to ensure that the program could be started on schedule. Non-critical system elements were not ignored but, on the other hand, they were assigned relatively low priorities during this initial development phase.

  We do not disagree with the above approach **during the development phase**. However, one of the key findings is that the final development phase payment of $2.15 million was not authorized until October 1992, **after** the program was repealed. There was ample time in mid/late 1992 to complete a full system test and review, and to follow contractual procedures for DOI sign-off.

- *Turnkey Contract* -- Because of the program's complexity and the magnitude of the contractor's role in administering it, the Department requested that the contractor provide "turnkey" services. This included relying on CSC to follow the system development procedures outlined in its proposal, which

assumedly would ensure proper quality control in the design, testing, and implementation process. The contractor also was required to support the program's contract management activities by providing various quality control and expenditure reports. Finally, the contractor was required to certify that all deliverables and requirements associated with each invoice it submitted had been completed. We were told that CRER program management relied on these turnkey provisions of the contract to supplement and, therefore, minimize their contract management efforts.

The position that a turnkey contract for $66 million justifies less than comprehensive contract management attention may be defensible in legal or technical terms. Our view, however, is that it is not defensible in terms of good management practices. Moreover, it is inconsistent with the budget and organizational responsibilities assigned by DOI to its CRER contract management unit. If the contract did not need close monitoring and review, then five full-time positions would not have been necessary.

- *Length of the Contract* -- Because the contract covered a period of over five years, it was envisioned that any non-critical system components would be identified and implemented as appropriate during the long operations phase. However, repeal of the program significantly reduced the amount of time available for this purpose and for completion of a full audit of system requirements.

  We again point out that the major final development phase payment of $2.15 million was not made until October 1992. DOI could have employed staff to fully review the system before making the payment. Now it is paying R & G Associates to do this type of work on a retrospective basis, without the strategic benefits related to withholding the final system development payment.

We fully recognize that the Department faced a difficult and unusual situation in implementing the CRER Program. Nevertheless, the additional rationale offered by DOI management does not, in our view, justify or rationalize the contract management weaknesses reported previously.

Conclusion

The implementation and administration of the CRER program was largely conducted by Computer Sciences Corporation in its role as the fiscal intermediary and claims adjustment firm. Because of the significance of this role and size of CSC's contract, effective management of CSC's activities was important. However, in several key respects, the Department's management of its primary CRER contractor was not adequate or effective. There were extenuating circumstances associated with DOI's contract management approaches, particularly the decision to leave four of five budgeted contract management positions vacant after April 1992. Nevertheless, these factors do not obviate the need to (1) monitor contractor performance and charges more closely, (2) ensure that contractual requirements are met, and (3) establish reasonable performance criteria for payment of services. If the primary contract had been managed more carefully, the current dispute between CSC and DOI possibly could have been avoided, as well as the extra costs associated therewith.

Chapter 4 Claim Payments For Damages Were Calculated Accurately But Various Other Aspects Of Claims Processing Failed To Meet Requirements Established By Regulations Or Policy

Chapter Summary

This chapter discusses findings regarding how the CRER Fund processed claims and calculated program benefits. A random sample of 430 of the approximately 14,200 claims filed and processed during the Fund's one year of operation was reviewed to document compliance with regulations governing the program. Each claim file was examined for over forty separate functions to track each step of the claims adjustment process. Approved claim amounts were verified to ensure that payments were calculated accurately. Review of the claims files also yielded information to determine the efficiency and effectiveness of the Fund's claims processing performance. With the exception of the 90 day appeals analysis, all summary statistics in this chapter were derived from our sample data.

In reviewing the claims adjustment process, we found that claim payments for damages were calculated accurately. However, various other aspects of CSC's claims processing failed to meet requirements established in program regulations or policies. Specifically, documentation in the claim files verifying eligibility was inconsistent, and the amount of time required for CSC to process claims exceeded the maximum time limit established by the program's regulations in more than half the files in our sample of 393 claims.

Background

According to Article 5, Section 2698.9d of the California Code of Regulations, the CRER Program or its contractor had sixty days from the time a claim was initiated to process it and to notify the claimant by mail of its outcome. In that same sixty-day period, according to Section 2698.9e, information on approved claims had to be submitted to the State Controller's Office in order for payments to be made. CRER Program claims processing services were performed under contract by CSC.

After an earthquake, homeowners typically called the Department's toll free line to report property damage caused by the quake. After a homeowner initiated a claim, CSC was responsible for:

- Verifying the claimant's eligibility
- Arranging for an adjuster to appraise the damage to the home
- Reviewing the adjuster's report to ensure that the type and cost of repairs were within Fund guidelines
- Deciding whether the claim should be paid
- Calculating the correct payment amount if appropriate
- Informing the State Controller of the amount to be paid to the homeowner.

CSC's automated information system was to provide an instant eligibility check on claimants based on the information submitted by insurers. In addition, paper files for each claim were created and maintained to document all claims processing activities. The information system and the paper files were intended to be used in tandem throughout the claims review process. We were able to review the paper files; however, we did not have access to the automated system. The automated system ceased operating once the CSC contract was terminated in May 1993.

Once CSC processed the claims, they were grouped in batches according to file status (approved, denied, or others such as duplicates and voids), and presented to the Department. DOI staff then reviewed the cover sheets on the batches and the Department's Project Manager signed off on the processing accuracy/compliance of batches. Individual files were sampled by the one person assigned to the batch review function, with the emphasis of this sample review focusing on the correctness of the claims adjusting/payment calculation steps. DOI management indicated that at least 10 percent of the claims in each batch were sampled and that overall, approximately 30 percent of all claims were reviewed. The Project Manager also reviewed a small sample of files when he signed off on the batches, again focusing on the accuracy of payment calculations.

After DOI approved the batches of claims, they were returned to CSC. Information supporting payment of each claim then was sent

by CSC to the State Controller's Office. The Controller issued and mailed checks to approved claimants; CSC also sent a separate letter to each claimant explaining the results of the claims process and informing them of their appeal options, when applicable. Several different types of appeals existed within the CRER Program as described below.

- *Eligibility Appeals* - Claimants found to be ineligible for program benefits could appeal the decision by writing to the CRER Program within 30 days of the date on their notification letter. The program was required to respond to eligibility appeals within 20 days of their receipt. The Department was responsible for administering eligibility appeals.

- *First Level Payment Appeals* - Claimants found eligible for program benefits but dissatisfied with the amount of payment could appeal the decision by writing to the program within 30 days of the date on their notification letter. This was known as a first level payment appeal. The program was required to review the claim and send a written decision within 45 days of receipt of the appeal. CSC administered first level payment appeals.

- *Second Level Payment Appeal* - Claimants could request a second level payment appeal if they disagreed with the result of the first level payment appeal by writing directly to the Department of Insurance within 15 days of their receipt of the appeal decision letter. This second level payment appeal was reviewed by an independent hearing officer hired by the Department who was required to send a written decision within 60 days of receipt of the appeal request.

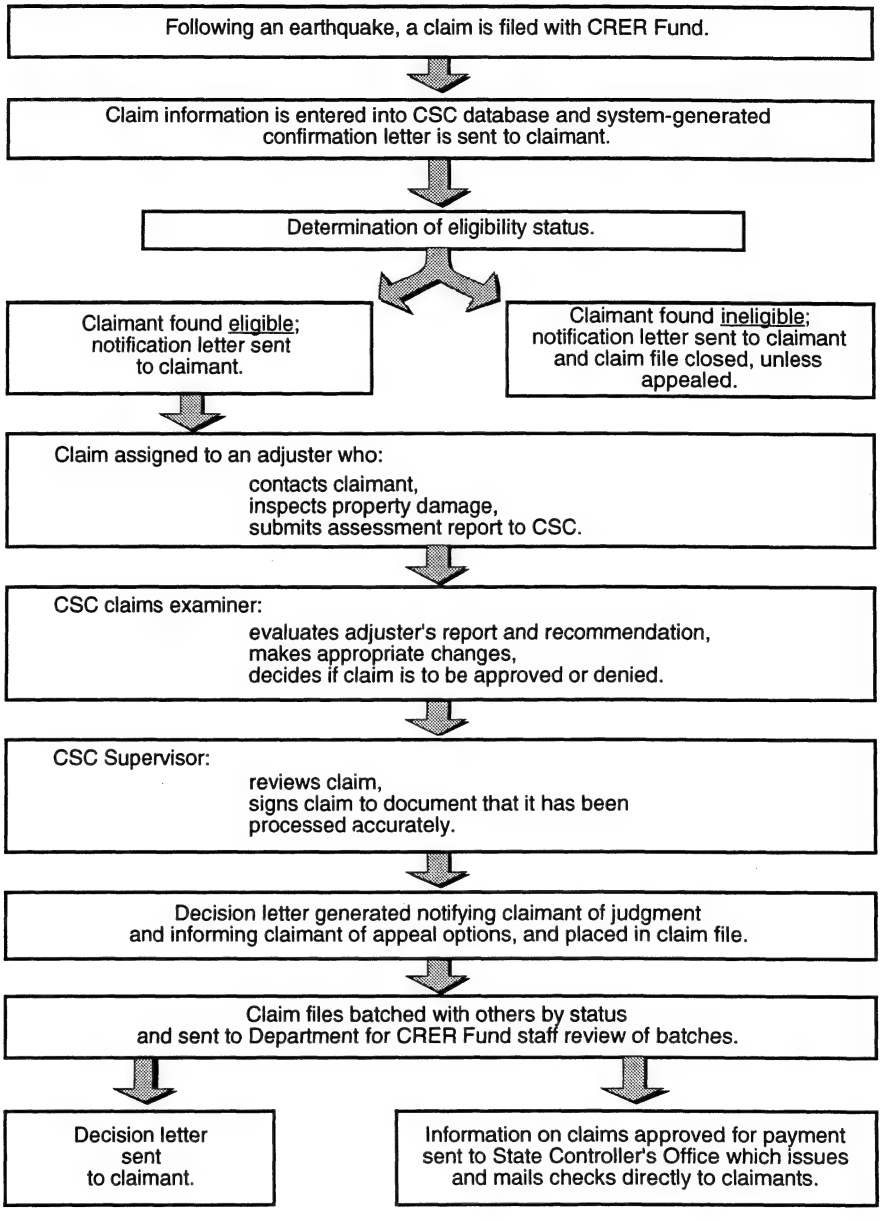
- *90 Day Appeals* - Homeowners had 90 days in which to make a claim for program benefits following a Qualifying Earthquake Event. Events covered a seven-day period starting from the date of the initial quake and including any aftershocks occurring the following week. If extenuating circumstances prevented filing within 90 days after the event period, claimants could appeal in writing to have their claim processed as if it had been filed within the 90 day period. The Department was authorized to accept late claims when circumstances were beyond the claimant's control, or if structural damage was discovered after the filing deadline. An independent hearing officer hired by the Department decided cases when the appeal did not readily identify an acceptable reason for making a late claim.

In an interview with CSC representatives, we were told that detailed desktop manuals had been created for all functions conducted by CSC, including claims processing. Upon initiating our audit of the claims processing function, we requested a copy of the manual to compare these written procedures with the actual claim processing operations, as documented in the claims files. The only instruction guide made available to us was a general overview which explained the common types of damage that resulted from earthquakes, and what was expected from the adjusting companies assigned to make site inspections. After several formal requests, a detailed manual which described step-by-step claim processing requirements and use of the automated information system ultimately was furnished the week after all field work for the audit had been completed.

Prior to receiving the manual, we developed our own summary of the process based on documents describing the program, regulations, and the results of our review of 430 claim files.

Our summary was confirmed by a CRER Program staff member who was responsible for approving all CSC processed claims before they were signed by senior program managers and sent to the State Controller's Office. Our summary of the process is shown in **Table 4.1**, on the following page.

Table 4.1
Schematic Of CRER Fund
Claims Processing Procedures



Input Of Claims Date Was Accurate And Prompt Based On Findings From Our Sample

The first step in the claims processing procedure was to record information from the claimant and enter it into the computerized database. Phone operators would write information about claimants on a standardized form which later was keyed into the information system. The system then generated a letter acknowledging the receipt of the claim, advising the claimant what to expect next, and identifying the reference number assigned to the claim. Of the 389

claim acknowledgment letters reviewed in our sample of 393 claims,[2] 311, or 80 percent, were generated on the day the claimant initiated contact with the CRER Fund. The average time to generate the letter for all claims was one day. This indicates prompt claims acceptance and initial data entry operations.

The Eligibility Verification Process Was Not Properly Documented In The Claims File And Exceeded Regulation Time Limits, Based On Findings From Our Sample

Our sample disclosed that one or more documents verifying eligibility for all 245 claimants recognized initially by the system as eligible were in the files. For the other 148, however, 64 (43 percent) had no eligibility documentation. This includes 31 claims which were approved; that is, documentation which verified that the system recognized these claimants as being eligible was not included in the file, nor was there any other documentation of eligibility, yet payment was made to the claimant.

Table 4.2 summarizes our sample results as to file documentation of claimant eligibility.

Table 4.2
Summary Of Claims Documentation

Approved Claims

	Recognized by System		Not Recognized by System		Totals	
	Actual Number in our Sample	Percent	Actual Number in our Sample	Percent		
Eligibility documentation	142	100%	52	63%	194	86%
No eligibility documentation	NA	NA	31	37%	31	14%
Totals	142	100%	83	100%	225	100%

[2] Note: 430 claim files were reviewed in our random sample, but not all 430 files contained fully processed claims. Of the files in our sample, 37 were classified as duplicate, voided, aborted or withdrawn claims. The total number of claims in our sample which were entered into CSC's computer system (393) is the sum of the approved (225), denied (152), and ineligible (16) claims. Four of the 393 files did not have claim acknowledgement letters.

Table 4.2 (continued)

Denied and Ineligible Claims

	Recognized by System		Not Recognized by System		Totals	
	Actual Number in our Sample	Percent	Actual Number in our Sample	Percent		
Eligibility documentation	103	100%	32	49%	135	80%
No eligibility documentation	NA	NA	33	51%	33	20%
Totals	103	100%	65	100%	168	100%

We also noted that 142 of the 393 files that were reviewed did not contain copies of eligibility letters. These are letters that had to be sent to claimants notifying them that they were eligible under the CRER Program. This amounts to about 38 percent of the files on the 377 eligible claimants.[3]

CRER Program management did indicate that a separate system was used to file eligibility verifications received directly from insurers. Once a manual verification was received from an insurer, the claimant's status in the system was updated and the actual verification document was batched with other verification documents and filed. However, a link did not exist between the individual claim files and this separate eligibility documentation filing system.

The program also did not inform ineligible claimants of their status within required timeframes. Section 2698.9b of the Regulations state that claimants found ineligible for program benefits must be mailed notification of such findings within seven days of the date their claims were made. Based on our sample, however, CSC took an average of 48 days to send letters informing ineligible claimants of their status. Letters informing eligible claimants of their status were sent, on average, 37 days after claims were made; however, notification letters affirming eligibility were neither regulated nor required by law.

As noted previously in the "Background" section of this chapter, DOI program staff were not required to review individual claim files

[3] The total number of approved (225) and denied (152) claims in our sample is 377, plus 16 other claims determined subsequently to be ineligible.

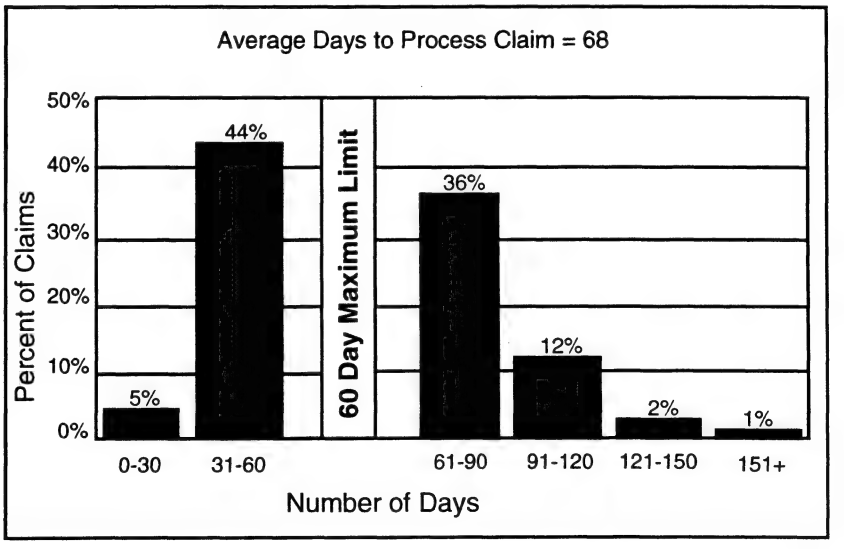
for compliance with regulations, policy, or other contractual requirements. The Department's review and signoff was completed only for batches of claim files (except for sampling of individual files).

Claims Processing Exceeded The Maximum Time Limit In More Than Half Of The Files In Our Sample

Regulations required that a claimant be notified in writing of the decision on his/her claim within 60 days from the date it was filed. Information on approved claims was to be sent to the State Controller's Office within the same 60 day period. Of the 374[4] claims with decision letters in our sample, 193 (51 percent), failed to meet these requirements. Our review showed that all versions of the decision letters sent to claimants were dated an average of 68 days after the claim was initiated. However, these notifications to claimants (produced by CSC) were **not** mailed by the date on the letter because they were first batched and forwarded to the Department for approval and sign off by a senior CRER Program manager. This took approximately one week and indicates an even longer processing time and a greater percentage of files which failed to comply with the regulations.

The distribution of claims processing time is shown in **Table 4.3**.

Table 4.3
Days To Process Claims



[4] Total decision letters include 220 approved claims, 138 denied claims, and all 16 ineligible claims. Decision letters were missing for 5 of the approved claims and 14 of the denied claims. The ineligibility letter sent to claimants by CSC was counted as a decision letter for the purposes of this calculation.

Approved claim files did not contain documentation on when they were sent to the State Controller's Office. **Dates** on the decision letters for approved claims also averaged 68 days after the claim was first made. Since decision letters were generated before approved claim information was sent to the Controller, we can conclude that this second 60-day requirement was not met in at least 51 percent of the claims in our sample.

Processing time for the claims in our sample was not affected by the amount of additional adjustments made on the loss estimate, the flow of claims which were initiated at the same time, or the amount of the final payment made to the claimant. Differences in processing times between approved and denied claims did not prove to be significant. Thus, the lengthy processing time was consistent across all types of claims and was not attributable to any distinguishing variable which might have caused a delay.

Sample Results Indicate That Claim Payments For Damages Were Calculated Correctly

Based on the data in the claims files we sampled, the approved amounts paid to homeowners for earthquake damage were calculated correctly. We could readily determine that the appropriate deductibles and maximum payment levels were applied accurately in all but four of the files we reviewed. For these four claims, further inquiries with DOI staff determined that the calculations were reasonable and accurate. Benefit payments were made in 225 claims, and the average payment was $5,757. Denied claims were most often due to:

- Damage amounts of less than the CRER Fund deductible (minimum of $1,000)
- Lack of structural damage caused by the qualifying earthquake event.

According to estimates provided by CRER management, $53,417,000 in benefits was paid out to approximately 8,300 homeowners who experienced qualifying damage during 1992. Based on these figures, the average payment was about $6,436 per approved claim.

Few Eligibility And Payment Appeals Were Requested

Based on the cases in our sample, eligibility and payment appeals were requested by a very limited number of claimants. Four of the 393 files we examined (about 1 percent), contained eligibility appeals, and of these, three were identified as eligible to receive program benefits. Approximately six percent, or 23 files, contained first level payment appeals. Nine of these appeals resulted in supplemental payments to claimants. Three of the files (less than one percent) contained second level payment appeals, and of these, none were granted. Using the frequency of these appeals as a measure of effectiveness and claimant satisfaction with the claims adjustment process, the CRER Program performed well.

First Level Appeal Processing Time In Our Sample Exceeded Regulation Limits

An analysis of cycle times for notification of first level appeal decisions indicates that they were not in compliance with the time requirements set forth in the Regulations. Just four, or 17 percent, of the 23 first level payment appeals were decided within the 45-day time requirement. Sufficient documentation to track cycle time is lacking in several of the eligibility and second level appeal cases due to missing forms. Further, the small number of these types of appeals (7 out of 393 claim files) in our sample would indicate only very tentative conclusions. Of those with complete documentation, only one was decided within the regulation time allowance.

Administration Of 90 Day Appeals Generally Complied With The Regulations

Residents who wanted to file a claim after the 90 day period following an earthquake event had to request a 90 day appeal. These appeals were administered by the Department, not CSC, and were separate and distinct from the claims CSC processed. Nearly 800 homeowners requested 90 day appeals. Our analysis was based on the **actual data for all 90 day appeals** provided to us by CRER Fund staff. Of these appeals, 752 (94 percent) were granted and referred to CSC. CSC then processed these accepted appeals in the normal fashion as if the claim had been filed within the 90 day period. Most of these residents filed late claims because they discovered structural damage after the filing deadline, or because they delayed filing a claim due to circumstances beyond their control (e.g., not aware of the program, serious injury or illness, personal issues, etc.). According to the Regulations, appeals in these cases were to be approved.

Cycle time analysis for the 90 day appeals shows that 646 (81 percent), of these appeals were processed within the 60 day maximum limit. On average, 90 day appeals were processed within 46 days from the date the request was received by the program.

Conclusion

Over 14,200 claims were processed by CSC, with DOI review. According to the program's estimates, $53,417,000 in benefits was paid out to approximately 8,300 homeowners to help repair structural damages from earthquakes in 1992. Our review of a random sample of claim files found that claim payments were calculated accurately.

The CRER Program and its contractor fell short, however, in complying with the California Code of Regulations concerning the maximum time limits required for claims adjustment services in over half of the claims processed. In addition, eligibility documentation and other paperwork in the claim files were inconsistent.

Chapter 5 The Pro Rata Refund Methodology Used By The Department Was Reasonable And The CRER Program Does Not Appear To Have Any Unfunded Liabilities

Chapter Summary

This chapter discusses the Department's pro rata methodology which was used to refund surcharge payments to program participants. In addition, outstanding program liabilities as of January 1994 are identified, as well as the estimated final CRER Fund balance once all program activities have been completed. This assessment is based on a review of financial reports, internal memoranda and planning documents, as well as interviews with CRER management.

Our analysis has concluded that the pro rata refund methodology used by the Department was reasonable. As part of the methodology, the Department prudently established reserve accounts for activities which could not be completed by the time refunds were issued. In addition, the Department's review of the actual refund payments calculated by CSC was reasonable, although it was not formally documented. In addition, the assumptions used in the pro rata refund methodology also were not fully documented. Based on information provided by Department, the CRER Program does not appear to have any unfunded liabilities.

Background

The repeal legislation required the Department to refund surcharges paid by policy holders on a pro rata basis. In order to determine the CRER Fund balance available for refunds, the Department first had to determine its actual costs for program administration and the payment of claims, and project future operating and termination costs.

The Department, working with CSC, developed and refined the methodology to be used in determining the amount to refund to policy holders. During this process, various reserves were established to account for specific program liabilities. These liabilities included:

- Administrative costs to fully terminate the program
- Claims which had not been fully processed

- Surcharge refunds which were delayed due to unresolved data problems

- Litigation expenses.

Because pro rata surcharge refunds were issued prior to completing all program activities, the reserve estimating process was particularly important. Program management had to ensure that adequate reserves were established to cover all outstanding liabilities, while at the same time ensuring that the reserves were not excessive.

The task of estimating outstanding liabilities was complicated by various technical and administrative difficulties that the program faced during the termination process. For example, the Department originally established January 15, 1992 as the last day that any type of claim would be accepted. This was necessary to determine the amount of funding that should be reserved to pay outstanding claims before issuing pro rata refunds. Subsequently, however, the Office of Administrative Law opined that this date is not valid for certain types of claims, as is explained in more detail later in this chapter. Also, other difficulties experienced during the termination process included various problems with the CRER Information System database which have resulted in unanticipated additional payments to selected groups of program participants.

The Pro Rata Refund And Reserve Account Methodology Used By The Department Was Reasonable

Based on our evaluation of the key documents identified previously, the approach and review process taken by the Department and CSC to determine the pro rata refunds appear reasonable and sound. This work started in December 1992 and continued throughout the spring of 1993. On January 12, 1993 the Department agreed in concept with CSC on the methodology to be used. They then went through three major iterations of this methodology during the spring of 1993 in continuing efforts to refine the revenue, cost, and refund reserve numbers. These iterations represented progressive refinements and firming up of the various accounts in order to maximize the amount of refunds to policy holders. The iterations generally involved analyzing the anticipated revenue at the individual insurance company level and quantifying the extent of each company's surcharge data problems. This included, for example, gauging the amount of problem records that would remain from the "Suspense File" and "Cash/No Data" records that were not accepted by the system. In addition, Department staff calculated the actual costs to date and estimated projected costs for program termination.

The methodology and various iterations were structured to derive a ratio of the amount of revenue available for refunds, based on identifying total revenue less total actual and projected costs. The third iteration resulted in the final ratio of 56.9 percent as the pro rata refund amount. This ratio represents the amount of revenue available for refunds after all costs are paid, as a percent of total revenue received. This means that 56.9 percent of every surcharge dollar was returned to policy holders who had paid the surcharge. Conversely, 43.1 percent of every surcharge dollar was used to cover all actual and projected program administration costs, contract costs, future refunds due to problem records, and claim payments.

The Department set the minimum refund amount at $2 because the administrative cost of processing amounts below $2 equalled or exceeded the refund value. Program participants who would have received a refund of less than $2 included those who paid the surcharge in quarterly or monthly installments and, thus, did not pay for a full year's coverage. The total number of program participants who would have received a refund of less than $2 was only 18,834.

During the months of May and June 1993, 4.4 million refund warrants were issued totaling about $125.8 million. The average refund for each program participant was $28. During this initial refund period, warrants were issued to 96 percent of all homeowners who paid the surcharge.

The Final Pro Rata Refund Ratio Was Not Approved Formally

Although the refund method used and the review process between the Department and CSC were both reasonable, we did not find evidence of formal, written Department approval of the *final* refund ratio (i.e., 56.9 percent) and final reserve figures prior to calculating the actual pro rata refunds. CRER management noted that they did, however, give verbal approval, and that key CRER management worked very closely and continually with CSC staff during these last few weeks in reviewing and refining the final figures used for the pro rata refund. A formal approval of the refund ratio was not specifically required in the termination agreement; however, formal documentation of the approval would provide verification of the review process.

The Department Conducted A Reasonable Review Of Surcharge Refunds

We examined the Department's efforts at reviewing calculated pro rata refunds prior to their release. We were provided documentation that indicates all reports were reviewed and approved in writing for those refund warrants that were above the pre-defined refund level (i.e., more than 56.9 percent of the maximum or minimum surcharge). Refunds would exceed pre-defined levels when a homeowner had policies for more than one residence, such as duplex or triplex owners, or paid the surcharge for more than one year. CRER management indicated that a sample review was conducted of refunds falling below or within prescribed limits before refund tapes were released to the State Controller's Office for issuance of warrants. However, this latter review was not documented.

The Documentation Of The Final Pro Rata Refund Reserve Methodology And Assumptions Is Not Adequately Integrated

In conducting our evaluation of the assumptions and the methodology used to calculate the pro rata refunds, the Department was unable to provide a single, comprehensive document which clearly explained these issues. Instead, it provided the following:

- An April 20, 1993, letter from the Department to CSC which provided the final fund balance for use in the pro rata determination
- The Available Fund Balance Report dated April 29, 1993, which was generated by the information system administered by CSC (report FX-FB506C)
- The "Final Results from the Refund Process", which was a document prepared by CSC and dated May 7, 1993.

Even when these documents were considered collectively, it was not possible to identify all the assumptions used in determining the pro rata refund. For example, the amounts reserved for specific liabilities differed in the various documents and the reasons for these differences are not fully explained in the back-up materials. CRER management indicated that these differences can be attributed to additional refinements which were being made to the reserve accounts before the pro rata refund amount was finalized.

The document entitled "Final Results from the Refund Process" (dated May 7, 1993) was intended to provide documentation of the assumptions which were in the surcharge methodology. This document does identify most of the assumptions but there are a few

key assumptions missing. First, the document does not identify the total costs for actual program administrative costs to date or the projected administrative costs for termination activities that had to be completed after the initial pro rata refunds were sent to program participants. In addition, this document does not describe how the "Cash/No Data" or the "Insurer Overpayment" refund reserve was derived. The other documents provided by the Department also did not include these key assumptions.

Prior to final program termination, the Department should fully document the methodology and assumptions used to determine the pro rata refunds for future reference.

The Department Projects That The Fund Will Have A Positive Balance Of Over $3 Million After All Anticipated Program Activities Have Been Completed

Program management currently anticipates that all activities related to the termination of the program will be completed by March 31, 1994, with the exception of the new claims from 90 day appeals that must be processed based on direction from the DOI legal division. The Department anticipates that processing of these new claims will conclude in September 1994. A summary of anticipated program expenditures has been prepared for the remaining activities which include archiving records, transferring undeliverable warrants to the State Controller's Office, and processing claims resulting from 90 day appeals. Corresponding fund balance information also was provided. The document containing this information is entitled "Provisional Summary of Allocations, Expenses, and Projections as of 1/26/94".

Table 5.1, on the next page, provides a summary of the Fund balance as of January 1994, identifies projected expenses for the period January 1994 through June 1994, and provides the projected Fund balance as of July 1994 (including forecasted claims payments through September 1994). Note that the expenses shown include the estimated cost to process 140 claims resulting from 90 day appeals.

Per the original CRER Program legislation, the Fund's accumulated interest does not have to be transferred to the state's General Fund. The view of DOI legal counsel is that this money is available to support program operations, claims payments, and any termination activities. Thus, this interest is included in the DOI's projected Fund balance shown above. In the event that there is a positive Fund balance after three years, including interest and after **all** program costs are paid, DOI management states that the amount available probably will be transferred to the General Fund.

Table 5.1 is based on the most current data available from CRER management. However, because program termination activities are ongoing, this information will change as more accurate projections are available.

Table 5.1
Summary Of Outstanding Liabilities And Fund Balance

	Balance Available as of 1/94	Projected Expenses 1/94-6/94	Available Fund Balance as of 7/94
State Operations			
Salaries and Wages	$ 637,783	$ 123,749	$ 514,034
Operating Expense and Equipment	1,874,590	1,227,910	646,680
Local Assistance			
Claims	85,962	0	85,962
New 90 day Claim Appeals	561,000	561,000	0
Pro Rata Refunds	390,029	390,029	0
Insurer Reserves			
Cash No Data	618,557	458,948	159,609
Surcharge Expense	2,169,478	1,475,948	693,530
Insurer Fund Overpayment	66,219	17,736	48,483
Forced Place Policies	148,000	286,740	(138,740)
Other Contingencies			
Litigation Expense	0	500,000	(500,000)
Duplicate Posting Issue	0	1,500,000	(1,500,000)
Subtotal: Fund Balance	**$6,551,618**	**$6,542,060**	**$ 9,558**
Accumulated Interest	**3,124,544**[a/]	**0**	**3,124,544**[a/]
Fund Balance Including Interest	**$9,676,162**	**$6,542,060**	**$3,134,102**

a/ Interest accumulated as of June 30, 1993. Some additional interest will be earned by July 1994, perhaps as much as $500,000.

The Department Has Reserved $500,000 For Potential Litigation Expenses

In the document entitled "Provisional Summary of Allocations, Expenses, and Projections as of 1/26/94", the Department has reserved $500,000 for litigation expenses. This reserve is for expenses related to the resolution of a current contract dispute with CSC, including the cost of legal counsel and litigation support activities. In addition, potential litigation expenses related to the payment of claims is included in this reserve. Although the Department has been able to resolve all disputes related to claims payment without legal action, program management has indicated that there are three pending disputed claims.

The Department Has A Potential Liability For Processing Additional Claims Beyond What Has Already Been Reserved

As described in Chapter 4, "90 day appeals" involve situations where homeowners allegedly did not discover the earthquake damage, or could not file their claims, within the prescribed limit of 90 days following a Qualifying Earthquake Event. The DOI had established January 15, 1993 as the cut-off date for accepting these types of late claims. However, a recent opinion by the Office of Administrative Law directed the Department to accept and process 134 new claims associated with late 90 day appeals. These 134 claimants had submitted a written request seeking a 90 day appeal after January 15, 1993. The OAL decision did not set a new cut-off date for these claims; in fact, the decision left open the issue of when such claims must be filed.

The Department has budgeted program administration costs of $165,000 and reserved $561,000 for additional 90 day appeal claim payments. These amounts are included in the projected expenses shown previously in Table 5.1. These figures assume that 140 additional claims will have to be processed by the program, even though only 134 written requests were submitted.

Based on our review of internal correspondence and discussions with program management, the exposure to the Fund could conceivably be greater than the above referenced 134 claims. The Department will only accept 90 day appeals from those homeowners who submitted a written request for an appeal. However, it is estimated that 500 telephone calls have been received inquiring about filing late 90 day appeals. At this time it is unclear if the program will have to process additional 90 day claim appeals from homeowners who have not yet made their request for an appeal in writing.

The Department has not budgeted any funds at this time to process more than the 140 claims described previously. If the program accepts additional 90 day appeals and, subsequently, claims from the approximately 500 homeowners who telephoned inquiring about such appeals, there is a potential outstanding liability of up to $2,592,857. This estimate is based on the same processing and payment cost per claim used by the Department to budget for the 140 90 day appeal claims, and assumes that all of the approximately 500 homeowners who telephoned will submit appeals.

The estimate of an outstanding liability of $2,592,857 portrays an extreme, worst case scenario that is not likely to materialize fully because:

- The program ended over a year ago and, as time passes, there is a diminishing likelihood that homeowners will file formal 90 day appeals

- Even if 500 additional claims are filed, some unknown number probably would be denied or ineligible (about 40 percent of all claims received by the program have been denied or ineligible).

In any event, the Fund's accumulated interest constitutes a very reasonable reserve for the worst case scenario involving additional 90 day appeal claims. This statement is based upon the numbers in **Table 5.2**, below.

Table 5.2
Available Fund Balance Assuming
Payment Of 500 Additional 90 Day Claims

Available Fund Balance	$ 3,134,102
Estimated Liability for 500 Additional Claims	$ 2,592,857
Remaining Fund Balance	**$ 541,245**

Program management has indicated that regulations related to the processing of additional 90 day appeals are being prepared. These draft regulations limit the number of additional 90 day appeals that will be processed to the 140 claims, discussed previously. If this provision is included in the final regulations, the potential liability associated with additional claims, as described above, will be eliminated.

Conclusion

The methodology used to develop the pro rata refund percentage and the process for reviewing refund amounts was reasonable. However, "formal" approval of the final methodology and refund check amounts should have been documented, and the methodology itself should be described clearly in writing.

The Department has been reasonable and prudent in establishing reserves to account for remaining program liabilities. The Department estimates that the Fund will have a balance of $3,104,102 after all outstanding activities have been completed. While there is some uncertainty about the specific number of additional claims resulting from 90 day appeals that will have to be processed, and which are not reflected in this estimated fund balance, adequate resources are available to process these claims (based upon historical claim payment rates and amounts). Based on the information provided by the Department, the CRER Program does not appear to have any unfunded liabilities at this time.

Chapter 6 There Was Inconsistent Performance Of Program Administrative Activities, Primarily Due To Insufficient Staffing

Chapter Summary

This chapter presents the results of our review of several additional administrative and programmatic responsibilities of the Department, including the development of regulations and policies, program staffing, administrative costs, allocation of indirect charges, and termination planning activities. **Exhibit III**, at the end of the section, summarizes many of the CRER Program elements that required some type of policy or procedural action during program implementation.

Our findings indicate that the Department's performance of certain administrative tasks was inconsistent, largely due to insufficient staffing. The potential repeal of the CRER Program clearly impacted the Department's decision to forego staffing two-thirds or more of the planned program management unit. Nevertheless, some important functions were not performed or were scaled back due to insufficient staffing, most notably contract management activities and certain fiscal and audit functions.

Background

As part of the process of implementing, operating, and terminating the CRER Program, the Department had to complete a number of administrative activities. These included:

- Adopting regulations and policies to carry out the program
- Developing program budgets
- Allocating indirect administrative costs for centralized Department services to the CRER Program
- Hiring and retaining staff members to manage and administer the program
- Preparing and implementing plans to terminate the program.

The CRER Program Was Staffed Substantially Below Planned Levels, Thereby Decreasing The Effectiveness Of Administrative Activities

When SB 2902 passed, the Department proposed 57 positions to implement and administer the CRER Program. The DOI's proposal acknowledged that the "legislation created a new program with complex responsibilities such as...overseeing a claims appeal process and developing experts in the earthquake field." A total of 36 positions ultimately were authorized and budgeted.

Due to the potential of program repeal combined with overall state budget cutbacks and hiring freezes, it was difficult for the Department to recruit and fill all 36 positions. The Department filled 7.2 equivalent positions during the program's first fiscal year and 14.3 positions in the second fiscal year. Many of the positions required trained personnel with insurance industry knowledge or experience. In these cases, the use of temporary hires for staff augmentation was not deemed satisfactory, nor were retired annuitants used, few of whom had the insurance experience required.

Employees who filled the positions during the operations phase performed a commendable job coping with numerous problems typical of implementing and operating any new program. However, understaffing continually hampered the Department's ability to effectively administer and manage the program. The impact understaffing had on the program's contract management function was discussed in detail in Chapter 3. In addition to the contract management weaknesses, various other functions were not performed or were scaled back due to insufficient staffing. The other program units which experienced insufficient staffing included:

- *Auditing*--1.5 positions filled vs. 8 budgeted
- *Fund Management and Accounting*--no positions filled before 1993 vs. 5 budgeted; one position was filled on January 1, 1993
- *Policy and Program Information*--no positions filled vs. 3 budgeted
- *Fund Analysis and Reinsurance Management*--1 position filled plus interagency agreements and outside contractors used vs. 13 positions budgeted.

Certain functions were not performed as a result of insufficient staffing, namely:

- Fund balance analysis was not performed on a timely basis

- "Incurred But Unreported" claim losses and "In Appeal" reserves were not posted to the operating general ledger monthly
- The internal operating general ledger was not reconciled to CALSTARS reports monthly
- Department expenses were not posted promptly in the operating general ledger.
- Periodic fiscal reports produced by the CRERF Information System were sometimes filed without review.

The Department's decision not to fill *all* thirty-six budgeted positions is understandable, given the impending threat of program termination during the first half of FY 1992. However, FY 1991/92 staffing of only 2.5 out of 29 positions in the four units cited previously seems inordinately low and, potentially, hazardous. Also, during the termination phase, the Department has been able to hire staff through temporary agencies, limited-term positions, and the retired annuitants program. In addition, Department personnel from other divisions, including Technical Services and Administrative Services, assisted with specific termination activities. Given the administrative activities that were not completed due to lack of staffing, these options might have been employed earlier in the program's life cycle, in order to ensure that critical administrative tasks were completed adequately

DOI Method To Allocate Indirect Departmental Overhead Expenses To The CRER Fund

The method used by the Department to allocate indirect overhead costs to the CRER Fund is one used widely by governmental agencies. It relied on *budgeted* program positions as a percent of total DOI budgeted positions as the basis for calculating the percentage of overhead costs charged to the Fund. This resulted in overhead charges of $198,851 for FY 1991/92, a partial year of program staffing, and $472,439 through April 30th of FY 1992/93. We could not easily obtain full year overhead costs for FY 1992/93 but note that the large increase that probably occurred by year-end was due principally to:

- A full year of allocations
- A large increase in the pool of total DOI overhead costs as compared to the prior year.

The allocation method used in this case is the one used throughout the DOI. Although technically valid, it means that during FY 1991/92 and FY 1992/93, indirect costs were over-allocated to any division within the Department with a significant number of unfilled positions, such as the CRER Program.

The Department indicated that effective July 1, 1993, it implemented a revised labor distribution system to facilitate allocating certain indirect overhead expenses based on actual rather than budgeted positions. This revised method of distributing indirect costs will result in a more reasonable allocation to the CRER Program during the final stages of the termination process.

Adequate Policies And Procedures Were Established

The Department developed regulations for the CRER Program based upon authorizing legislation. Policies and procedures consistent with requirements in the California Insurance Code also were established. **Exhibit III** at the end of this chapter provides a summary of the CRER Program requirements contained in the Insurance Code and the Regulations, and provides our assessment of the related policies and procedures which were developed and implemented during the program's one year of operation.

The Notice Of Insurance And Commercial Insurance Study Were In Accordance With The Insurance Code

The Commissioner was required by section 5009 of the California Insurance Code to issue an official notice which explained the CRER Program, it's coverage and limits, and the reason for the surcharge. On October 30, 1991, a notice fulfilling this requirement was mailed to insurance companies affected by the Fund's operations. Insurers were instructed to provide the notice to all of their policy holders at the time of renewal and to policy applicants at the time of application.

Section 5012 of the California Insurance Code required that a Study of Commercial Insurance be conducted by the Department of Insurance and submitted to the Governor and Legislature by January 1, 1992. The report was to address the availability, cost and adequacy of commercial insurance which would cover losses experienced by small businesses due to earthquakes. The Department produced a report in accordance with this requirements on January 1, 1992.

Administrative Costs For The Program Were $8.67 Per Policyholder, Or 16.9 Percent Of Surcharge Revenue Collected

The CRER Program began incurring administrative costs in July 1991 and they are estimated to continue through June 1994, a period of three years. Preliminary program activities actually began prior to July 1991, but these activities were minimal and were conducted by existing Department of Insurance staff. Administrative costs were incurred during three program phases including:

- Implementation--July 1991 through December 1991
- Operations--January 1992 through December 1992
- Termination--January 1993 through June 1994

Although definitive dates are assigned above to each phase of the program, certain activities associated with each phase were conducted outside the time periods noted. For example, the processing of surcharge data was technically an "operations" task; however, a significant amount of surcharge data was processed during the first three months of calendar year 1993. The costs for processing after December 1992 are included in the total cost for the termination phase. The Department was unable to provide a more detailed breakdown of administrative costs by program phase.

For the purpose of this analysis, administrative costs include following:

- CRERF Information System development
- Fiscal Intermediary Services provided by CSC
- Claims Adjustment Services provided by CSC
- Program termination activities conducted by CSC
- CRER Program staff
- CRER Program operating expense and equipment costs

Table 6.1, on the following page, provides a summary of the approximate administrative costs for each phase of the program.

Table 6.1
Approximate Program Administrative Costs By Phase

	In Millions
Estimated Program Implementation Costs	
CSC System Development	$ 4.7
DOI Administration	$ 0.3
Subtotal	$ 5.0
Estimated Program Operation Costs	
CSC FI and CAF Services	$ 23.5
DOI Administration	$ 1.3
Subtotal	$ 24.8
Estimated Program Termination Costs	
CSC Termination Activities	$ 4.4
DOI Administration	$ 2.5
Interagency Contracts (State Controller's Office, State Treasurer's Office, etc.)	$ 3.2
Subtotal	$ 10.1
Total All Program Costs	$ 39.9

A total of 4.6 million policy holders paid the CRERF surcharge. Utilizing this figure and the information provided in Table 6.1, the administrative costs per policy holder can be calculated. This information is presented in **Table 6.2**, below.

Table 6.2
Administrative Cost Per Policy Holder

Project Phase	
Implementation	$ 1.09
Operations	$ 5.39
Termination	$ 2.19
Total	**$ 8.67**

A second method of assessing the program's administrative costs is to consider these costs as a percentage of the total surcharge revenue collected. During the program's one year of operation, a total of $235.4 million in surcharges was collected. Utilizing this information and the data provided in Table 6.1, the program's administrative costs as a percentage of total surcharge revenue collected are presented in **Table 6.3**.

Table 6.3
Administrative Costs As A Percentage Of Total Surcharge Revenue Collected

Project Phase	
Implementation	2.1%
Operations	10.5%
Termination	4.3%
Total	**16.9%**

Because of the unique nature of the CRER Program, it is not possible to compare the performance indicators shown in Tables 6.2 and 6.3 to the performance of other organizations, such as private insurance companies. In addition, if the program had not been terminated, one-time implementation costs could have been spread over several years. Also, operations costs should have decreased (on a proportionate basis) as the new processes and systems were debugged and became more routine. Finally, the repeal of the program resulted in substantial costs which would not have occurred under normal operating circumstances.

The Department Developed Various Workplans For Program Termination Which Have Not Been Routinely Used Or Updated

Once the repeal legislation was signed, the Department developed several draft termination workplans. Program management noted that elements of these drafts served as the basis for the termination agreement with CSC. We found, however, that these draft workplans were never completed and adopted to guide the *entire* termination effort. While CSC's responsibilities and deadlines were identified, similar specifications were not prepared for termination activities to be completed by Department staff after May 7, 1993. These draft workplans initially envisioned either June 30, 1993 or September 30, 1993 as the final program closure date. Neither of these dates were adopted by the Department.

We also found that the CRER Program developed another detailed termination workplan on March 24, 1993. This plan focused on the activities that had to be completed by the Department and included specific tasks, start and end dates, identification of lead staff and their responsibilities, etc. Program management provided a memo to CRER unit supervisors at that time with instructions to expand on the details in the plan and to provide updates to the plan on a routine basis. The plan included termination activities through June 1, 1993, but failed to lay out the various Department duties expected after that

date. We found the March 1993, draft workplan was not completed, updated, nor used to aid in overall program management.

In the absence of an approved overall termination workplan which was actually used, management of the program termination was more informal and ad hoc in nature. The program did make extensive use of weekly manager meetings and progress reports from the various CRER program units, and this provided some structure and direction in the absence of a documented plan.

During the course of this evaluation, program management developed a workplan for the activities which have yet to be completed to fully terminate the program. This new workplan anticipates a final program closure date of March 31, 1994 (with the exception 90 day appeal claims). If this most current workplan is utilized, it should provide a guide for balance of the Department's termination efforts.

Conclusion

The Department's implementation of various administrative aspects of the program was satisfactory or better in some circumstances and less than adequate in others. The Department did develop regulations and policies for the implementation of the CRER Program, and acceptable procedures were utilized to allocate indirect costs to the program. However, the program operated with significant understaffing which impacted the performance of several key functions. In addition, termination workplans for the termination phase have not been followed, updated, or completed in an approved final form.

Summary Of CRER Program Policy And Procedural Requirements

A. Function: Surcharge Collections

Description	Insurance Code	Regulations	Assessment of Policy and Procedures Implementation
CRER Fund surcharge is mandatory and must be assessed on every residential insurance policy issued on or after January 1, 1992.	§5003(a); §5008(a)	§2698.1(b); §2698.18	Commissioner issued Official Notice requiring payment and instructed insurers to collect surcharges.
CRER Fund surcharge should be based on age, type and location of home with a minimum charge of $12 and a maximum of $60.	§5004(a)1 and 2		Rate matrix was developed for determining surcharge amounts and distributed to insurers so they could assess and bill the appropriate amount.
Insurers shall determine who qualifies for the program and collect from them the surcharge at the same time the policy premium is collected. If a policy is paid in installments, surcharge may be paid on an installment basis as well.	§5003(a)	§2698.1; §2698.2(a)	Some insurers billed for surcharges retroactively. No compliance check on this requirement.
Insurers may collect a fee of up to $1 per policy to cover collection expenses. By October 1, 1992, insurers must submit a description and explanation of the costs they incurred to collect surcharges. The total amount insurers receive in fees cannot exceed these administrative costs.	§5003(b); (no reporting requirement)	§2698.3(a) and (b); §2698(b)	Unclear how many insurers collected $1 fee; 25% of insurers submitted copies of billing statements showing a fee was charged. Very limited number of insurers reported their collection costs -- repeal passed before filing deadline. No compliance check on this requirement.
The surcharge and fee must be itemized separately on the policy bill.	§5003(a)	§2698.2(a)1	Department did not instruct companies to itemize surcharge and fee on the billing statement. Roughly half of all companies sent copies of their billing statements showing itemized surcharges and, where applicable, itemized fees. No compliance check on this requirement.
Surcharge receipts must be deposited in a segregated, interest bearing account.	§5003(c)	§2698.2(c)	20 to 25% of insurers failed to remit the interest on their surcharge deposits in one or more monthly submissions.
Insurers must transmit surcharge deposits and interest to the State Treasurer within 30 days from the end of the month in which they were collected.	§5003(c)	§2698.4	No check to verify that insurers complied with 30-day submission requirement.

Summary Of CRER Program Policy And Procedural Requirements

A. Function: Surcharge Collections (continued)

Description	Insurance Code	Regulations	Assessment of Policy and Procedures Implementation
At the same time they make their monthly deposits, insurers are to transmit relevant information on policy holders who paid the surcharge. Information on policy holders who refused to pay also must be transmitted.	§5003(c)	§2698.5	66% of insurers transmitted acceptable policy data with their surcharge deposits. 17% of insurers transmitted unacceptable policy data with their surcharge deposits. 17% of insurers did not comply with program requirements.
All policy holders who pay the CRER Fund surcharge are eligible to receive program benefits. Policy holders who have not been billed by their carriers are eligible for benefits as long as their insurance was in effect for 1992, and their premium was due on or before December 31, 1992.	§5003(d); §5008(b)	§2698(h)	Surcharges were deducted from approved claim payments when the policy holder had not yet been billed by the insurer.
Insurers must allow the Department to inspect records and conduct audits to ensure compliance with the CRER Act.		§2698.16; §2698.17	The Department audited two of the 133 insurance companies participating in the program.
Insurers must keep records for three years from the date of surcharge collection or until the date of the next Department audit.		§2698.15	The Department's Examination Division will audit insurers and may request surcharge collection records. According to Department's Legal Unit, this requirement was not invalidated by the repeal.

B. Function: Claims Processing

Description	Insurance Code	Regulations	Assessment of Policy and Procedures Implementation
Qualifying Earthquake Event is declared.	§5001.5(b)	§2698(o)	Sixteen qualifying events were declared in 1992.
Toll free phone lines and program address for assistance requests must be established.		§2698.8(a)1; §2698.8(b)	CRER Fund used Department of Insurance's 800 hotline; CRER Fund address: 3835 North Freeway Blvd., #100, Sacramento, CA 95834.
Telephone operators must possess ability to communicate in English, Spanish, Chinese, Vietnamese and Tagalog.		§2698.8(a)2	CRER Fund used AT&T's Language Line Services.

Summary Of CRER Program Policy And Procedural Requirements

B. Function: Claims Processing (continued)

Description	Insurance Code	Regulations	Assessment of Policy and Procedures Implementation
Set up temporary offices at earthquake site.		§2698.8(a)3	No temporary offices were established; CRER Fund sent a representative to FEMA and OES field offices.
Collect information from claimant within 90 days of earthquake event: • Claimant name and address • Date claim filed • Description of damage • Insurance carrier • Other insurance coverage.	§5005(e)	§2698.8(a)2; §2698.8(c)	Residents called into 800 line to make claims; phone operators took down information, which then was entered into the computer system.
Verify eligibility.	§5005(c)	§2698.9(a)	Eligibility was checked in the computer system and, if necessary, CSC staff contacted insurers directly. However, this was not always done in practice.
Send eligibility status letter to claimant. (Notify ineligible claimants within seven days of the date claim was made.)		§2698.9(b); notification within 7 days if ineligible	System generated eligibility status letter sent to claimants. Average days to send out: 37 days for eligible claimants 48 days for ineligible claimants.
Assign adjusting company to inspect damages.		§2698.9(c)	Adjusting companies were to be assigned and to make first contact with claimant within 72 hours of claim receipt. (This policy was suspended at the end of April, 1992 and does not appear to have ever been reinstated.) Inspection was to be made within 72 hours of contact. Adjuster report was due within two weeks of inspection.

Summary Of CRER Program Policy And Procedural Requirements

B. Function: Claims Processing (continued)

Description	Insurance Code	Regulations	Assessment of Policy and Procedures Implementation
Process claims and make recommendations: • Coverage for only structural damage • Maximum of $15,000 per property, claimant and quake • Less CRER Fund deductible of .05% of fire coverage; must be at least $1,000, but not more than $3,500 • No payments for losses covered by private earthquake insurance • Deduct CRER Fund surcharge if claimant has not yet been billed • Make pro-rata payments if necessary	§5001.5(a); §5005(a), (d); §5005.3; §5007(b)	§2698.14(b), (c)	Payments on claims appear to have been calculated correctly based on sample audit of files. No pro rata claim payments were ever necessary.
Review of claim file by supervisor.			99% of approved claims were reviewed by a supervisor.* 25% of denied claims were reviewed by a supervisor.*
Send processed claim files to DOI for approval.	§5006(a)	§2698.9(d), (e)	Claims were batched by type (approved, denied, voided, etc.) and reviewed by Department staff.
Notify claimaint of decision and reason for decision within 60 days.		§2698.9(d)	Decision letter was generated by system and placed in file before claims were batched for Department review. Average time to process claims and produce a decision letter was 68 days.*
Submit information to the State Controller's Office on approved claims within 60 days.		§2698.9(e); §2698.13	Files did not document when information on approved claims was sent to the State Controller's Office. More than 50% exceeded the 60-day limit.*
Administration of appeals: • Eligibility Appeals: within 15 days • First Level Payment Appeals: within 45 days • Second Level Payment Appeals: conduct hearing and respond within 60 days • 90 Day Appeals: conduct hearing and respond within 60 days.	§5010	§2698.8(c); §2698.10; §2698.11; §2698.12	Most common appeal was a First Level Payment Appeal.* 86% of the First Level Payment Appeals exceeded the 45-day limit.* Evidence on other Eligibility and Second Level Payment Appeals is inconclusive.* 90-Day Appeals were accepted 94% of the time. 19% exceeded the 60-day limit.

* Summary statistics are based on a random sample of 393 claim files conducted as part of this audit.

Summary Of CRER Program Policy And Procedural Requirements

C. Other Requirements

Description	Insurance Code	Regulations	Assessment of Policy and Procedures Implementation
Money in the CRER Fund shall be invested in the state's Pooled Money Account and may be used only for the following purposes: • Payments for structural damage • Program administration • Claims adjustment expenses • Purchase of reinsurance • Issuance and repayment of revenue bonds • Reduce earthquake hazzards by retrofitting dwellings.	§5002 §5006(b)		CRER Fund income from surcharges was used only to pay • Claims • Program administration • Claims processing expenses • Reinsurance premiums • Termination expenses • Pro-rata refunds to policy holders.
When the Fund reaches a one billion surplus, low-interest loans will be issued for retrofitting covered structures.	§5002.5		The Fund never reached a one billion surplus, therefore no loans were made.
Surcharge collections made by an insurer's broker or agent must be treated as if they had been made directly by the insurer.		§2698.2(b)	The Fund accepted surcharges submitted by insurers which had been collected by brokers or agents acting on behalf of the insurers.
Requests for administrative fee increases for future years must be in writing and can be made once a year. Fee cannot exceed collection costs. Insurers, agents and brokers decide among themselves how the fee shall be split.		§2698.3(c) §2698.3(d) §2698.3(e) §2698.3(f) §2698.3(g)	Program repeal after the first year invalidated this provision.
Insurers have fiduciary duty to the Fund, but can't make representations for the program.		§2698.6	Insurers were instructed to refer their policy holders directly to the DOI for information on program benefits and operations.
Condominium associations must give evidence of owner occupied units when making claims.	§5003(g)	§2698.8(d)	There was no evidence in our sample of claim files that this did or did not occur; claims procedures manual was not available in time for review of this issue.
The Department must provide information on claims processing to insurers who request it.		§2698.8(e)	The Department sent out the "Explanation of Program Benefits" to all insurers and provided other information upon request.

Summary Of CRER Program Policy And Procedural Requirements

C. Other Requirements
(continued)

Description	Insurance Code	Regulations	Policy and Procedures Implementation
The Department will study losses to small business caused by earthquakes.	§5012		The Department produced a study on small business losses due to earthquakes in January 1992.
In five years, the Commissioner will conduct a study of the CRER Fund's operations.	§5013(a)		Program repeal after the first year invalidated this provision.
After events where claims are paid, the Commissioner shall submit a report on program operations related to that event to the Legislature.	§5013(b)		One post-event report was completed. Subsequent legislation eliminated this requirement (AB 2824, 1992).
The CRER Fund Bond Committee is authorized to issue revenue bonds and notes.	§5020 - §5031		No bonds were issued during the year the program was in operation.
The Commissioner and Advisory Committee shall study the utilization of taxable revenue bonds.	§5032		A bond utilization study was produced by the Advisory Committee in January 1992.

Summary Of CRER Program Policy And Procedural Requirements

C. Other Requirements (continued)

Description	Insurance Code	Regulations	Assessment of Policy and Procedures Implementation
Neither insurers nor the state are liable for payments from the Fund.	§5007(a), (c)	§2698.14(a), (d)	No money outside the CRER Fund was used or pledged for use to pay claimants. All pro rata refunds to policy holders who paid surcharges were calculated after program costs and other reserve accounts were deducted from CRER Fund receivables.
Records and information used by the Fund are confidential and should only be disclosed to authorized persons.		§2698.19 §2698.20	In general, copies of claim files had name references removed when made available to non-CRER Program staff.
Claimants who do not pay the surcharge when billed are not eligible to receive program benefits. Failure to pay the surcharge will not affect a resident's current insurance policy, but continued non-payment could prevent renewal of the policy.	§5003(e)	§2698.21	Claimants refusing to pay the surcharge were not eligible for program benefits. Refusal to pay had no impact on their homeowner insurance policy.
Surcharges paid on a policy that has been canceled are not refundable unless they are force-placed policies paid by banks and other similar institutions.	§5003(f)		Surcharges were not refunded apart from the pro rata refund due at program termination. Banks with force-placed policies were an exception.
Commissioner may adjust the surcharge annually for changes in risk, conditions in the Fund, or construction costs, and shall report such changes to the Legislature.	§5004(a)3 §5004(b)		Program repeal after the first year invalidated this provision.
Commissioner may adjust the payment amount annually based on changes in construction costs and the available Fund balance.	§5005(b) §5005.1 §5005.2		Program repeal after the first year invalidated this provision.
Surcharges and fees are not subject to premium taxes.	§5008(c)		There was no indication that surcharges were taxed.
Fund is not a substitute for private insurance.	§5011		CRER Fund benefits covered only up to $15,000 (less Fund deductible) in the event of a catastrophic loss and did not replace private insurance. Commissioner's Official Notice sent to affected policy holders stated that the Fund's benefits would not substitute for private insurance.
Commissioner will appoint an Advisory Committee to assist with implementation of the Program.	§5011.5		An Advisory Committee was appointed and met at various times during the life of the program.

JOHN GARAMENDI
Insurance Commissioner

March 28, 1994

Kurt R. Sjoberg, State Auditor
Bureau of State Audits
660 J Street, Suite 300
Sacramento, CA 95814

Dear Mr. Sjoberg:

I would like to take the opportunity to thank you and the contract staff of Ernst & Young (E&Y) for providing a substantive audit review of the California Residential Earthquake Recovery Program and its termination. The overall finding that "Despite The Lack Of Enforcement Authority And Program Stability, The Department Accomplished The Fundamental Purpose of The Legislation" recognizes the effective and sustained effort that was maintained in starting and terminating a complex program within an extremely short time span. Through sustained efforts by my staff and its primary contractor, the Department collected $236 million in surcharges, processed 14,000 earthquake claims, accurately adjusted $54 million in claims payments, issued and tracked 4.4 million timely refunds to homeowners, and cleared up several hundred thousand residual data problems so all eligible homeowners received a refund.

Notwithstanding the excellent effort displayed by the E&Y staff, the Department differs with some of the statements, findings, and conclusions as reported in the draft audit report dated March 17, 1994. The Department addresses these in the attached response. However, the Department appreciates the many opportunities which the Bureau of Audits and E&Y staff offered for discussion of their findings during the on site work and the preparation of the final report.

If you need clarification or additional information, please contact Masako Dolan, Deputy Commissioner, at 916-322-9209.

Sincerely,

JOHN GARAMENDI
Insurance Commissioner

JG\MTD

Attachments

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RESPONSE TO THE TABLE OF CONTENTS

The Department finds that several entries in the Table of Contents are somewhat misleading or incomplete, and that in the interest of fairness and accuracy, they should be discussed and changed.

- *Table of Contents, Chapter 3 heading: "The Department Did Not Adequately Perform Its Contract Management Functions."*

  The Department of Insurance took a piece of imperfect legislation that required a tough and demanding program implementation schedule, and by methodically focusing on the critical tasks that had to be accomplished to run a good program, collected $236 million in surcharges, paid all claims correctly, closed down the program when and as required, and refunded all remaining money on time and in the right amounts, while reserving for all foreseeable contingencies and leaving no unfunded liabilities.

  Despite some of this report's conclusions, it is no exaggeration to say that the Department's handling of the program has been vindicated by the basic finding of this audit: "Despite the lack of enforcement authority and program stability, the Department accomplished the fundamental purpose of the legislation."

  After its exhaustive post-contract review, the Department has now concluded final negotiations with its contractor, Computer Sciences Corporation (CSC). As a result of those negotiations, CSC has withdrawn all but $100,000 of the $707,678 it originally claimed in its outstanding invoices to the Department. Given this final resolution, and taking into account the matters the Department addresses and analyzes in its response to the findings of Chapter 3, the Department would strongly emphasize its basic disagreement with the auditor's findings on the contract management issue. (1) *

- *Table of Contents, Chapter 4 heading: "Claims Payments For Damages Were Calculated Accurately But Various Other Aspects of Claims Processing Failed To Meet Requirements Established By Regulations Or Policy."* The Department clarifies in its responses to this chapter (and the related summaries) that it deferred certain contractor time requirements, because it knew of insurers' difficulties in posting surcharge data and determining program eligibility. The auditor may have misunderstood some of the documentation requirements. (2)

* The Ernst & Young comments on this response begin on page 97.

RESPONSE TO THE SUMMARY & INTRODUCTION SECTIONS

SUMMARY

- *Page S-2, paragraph 1, "The most significant deficiency identified during this evaluation was that the Department did not adequately perform its contract management functions." [Repeated on page S-5]* After completion of the operation and termination phases of the contract, the Department withheld the substantial last payment due under the contract and engaged experts to review CSC's contract performance. The Department also wished to validate its concerns about deficiencies in CSC's contract compliance, most of which became apparent only during the implementation of the refund process.

  The extensive documentation provided by our experts formed the basis for settlement between the Department and CSC. That this was both a prudent and successful tack is clearly evidenced by the fact that the Department has now concluded negotiations with CSC, and as a result of those negotiations, CSC has withdrawn all but $100,000 of the $707,678 it originally claimed in its outstanding invoices to the Department, which will therefore retain about 86% of the withhold.

  Much of the audit report and most of its critical findings deal with contract management issues. The Department briefly discusses several of these points below, in the body of this document.

- *Page S-6, paragraph 2 (2nd bullet), "some CSC invoices--including one for over $2 million -- were paid without insuring that all contractual requirements and sign-offs had been completed".* In October, 1992, the Department was highly focused on (1) the critical path issues that would yield an operational system *and* (2) the impending termination of the program. The program manager was aware of the state of the automated system. He determined that while not every requirement had been fully implemented, the system was functional enough to warrant payment while the remaining fixes were being made. As a result, he requested the contractor to submit a final development invoice, and on its receipt, he directed that it be paid.

  The goods and services provided by CSC were highly complex, and both CSC and the Department recognized the risk of latent defects and deficiencies in those goods and services. The Department paid CSC invoices

when it had ascertained CSC's *prima facie* compliance with its contractual obligations. However, only actual operation of the CRER Program software and other deliverables over a period of years could fully reveal the sufficiency of CSC's work.

The auditors presume that the Department prejudiced itself by paying CSC's invoices. That presumption is incorrect. The Department never waived any of its legal rights and remedies by paying any of CSC's invoices. The Department's contract with CSC addresses the risk that latent defects in CSC's deliverables and deficiencies in its performance could come to light after the Department paid CSC. Notwithstanding any approvals or payments given by the Department to CSC, the Department retained the right under its contract with CSC to (1) audit or examine various aspects of CSC's performance, (2) pursue recoupment for overpayments, (3) pursue any remedy or relief available under any of its general legal rights and remedies, and (4) demand that CSC remedy defects at its expense. (3)

- *Page S-6, paragraph 3 (3rd bullet), "The termination agreement with CSC did not link deliverables or performance criteria with payments."* All performance under the termination agreement was to take place within a time frame of only four months; all deliverables under the termination agreement were grouped at the end of that period. The termination agreement required progress reporting and noted milestones, and contained a substantial withhold provision to permit the Department to closely assess contractor performance. Finally, the termination agreement preserved all contract remedies and requirements available under the original contract.

This combination of factors allowed the Department to monitor and control all aspects of the contractor's termination phase performance. In fact, after exhaustive post-contract review, the Department withheld $707,678 out of a contract of $4.4 million at the end of the termination phase. The Department has now concluded negotiations with CSC, and as a result of those negotiations, CSC has withdrawn all but $100,000 of the $707,678 it originally claimed in its outstanding invoices to the Department, indicating that the Department's prospective assessment of the situation was accurate. (4)

- *Page S-6, paragraph 2 (4th bullet), "Some of CSC's claims processing requirements were not monitored and/or enforced by DOI."* The Department monitored claims processing by reviewing a sample of files drawn from each payment batch. Due to the unanticipated need to determine program eligibility manually and the significant difficulties many insurers had in complying with program data filing requirements, the Department formally waived certain time frames for claims processing.

- *Page S-6, paragraph 3, ". . . DOI's contract management approaches, particularly the decision to leave four of five budgeted contract management positions vacant after April 1992 . . . . If the primary contract had been managed more carefully, the current dispute between CSC and CDI possibly could have been avoided, as well as the extra costs associated therewith."* The Department notes that the auditor has understood some of the significant developments that led to CRER Fund staffing difficulties, but the discussion does not go far enough. It is particularly important to bear in mind that repeal on an urgency basis was thwarted by the earthquakes that occurred during the very period the Legislature took up the repeal issue. Further, the State mandated a 10 percent staff reduction at this time for all agencies, which prevented the Department from replacing staff as positions were vacated. For all practical purposes, the Department felt that full staffing was infeasible.

  Also, to imply that having full staffing for contract management would have avoided the Department's dispute with the contractor is unwarranted. Disputes may have been unavoidable due to the remarkably short time available for implementation and the enabling law's complete lack of enforcement provisions. These were the significant factors that caused or allowed disputes to arise. The legislative weaknesses -- not departmental or contractor planning -- were the catalysts for dispute. (5)

- *Page S-7, paragraph 2, "In addition, eligibility documentation and other paperwork in the files were inconsistent."* Due to late surcharge remitting by insurers and the earthquakes that occurred early in 1992, among other circumstances, the CRER Fund used two parallel systems to verify program eligibility, one automated and one manual. Records of manual eligibility verification were filed together and are available for audit purposes.

  The auditor was aware of the two systems but reviewed only the records placed in the claims files, not those filed separately. Separate methods of record keeping were consistent with the existence and use of two systems and would be inconsistent only if one system were in place.

  It is clear that the auditors did not fully recognize that two systems functioned and did not discern in each case how to pick up evidence of eligibility verification. The Department can unequivocally state that eligibility was always established before any claim payment was made. (6)

- *Page S-7, paragraph 3, "However, "formal" approval of the final methodology and refund check amounts was not fully documented, and the various documents which described the methodology were not adequately integrated, and thus did not fully describe the refund process."* The

program manager formally approved the final refund algorithm, the core of the refund methodology, on January 12, 1993. The Department then formally approved or transmitted further extensive documentation of the refund process. That documentation described revenue and expense information, reserve accounts, initial pro-rata percentages, refund schedules (amounts verified by region), and exception reports (checks too high or too low, pulled and reviewed for accuracy). The program manager reviewed the final iteration of the refund algorithm percentage on-site, met with CSC's project manager, and authorized use of the final percentage. (7)

- *Page S-8, paragraph 1, "These factors would appear to justify the decision not to fill all 36 budgeted positions. However, they do not seem sufficient to justify such extensive understaffing."* The program was understaffed, but this was a side effect of what prospectively was a prudent approach to hiring: Until positions were actually needed in program operation, those positions were not filled. The Department started with contract managers, then actuaries, and would have moved to examiners and others, but repeal interrupted this orderly hiring process. Nevertheless, once the program was repealed, the Department pulled in five experienced departmental staff to ensure orderly program termination. (8)

- *Page S-8, paragraph 2, "The administrative cost per policy holder was $8.67 and administrative costs represented 16.9 percent of the total surcharge revenue collected."* The auditors have acknowledged that the CRER Fund program was unique, and its expense load cannot be compared to that of the insurance industry. The cited statement, however, fails to factor accurately what was a three-year expense load against one year of revenues. One-time program expenditures were made in development ($4.7 million), the initial data load ($2.2 million), and termination ($4.4 million, excess of TPU processing), but in calculating an expense load, those expenses would appropriately be spread over a longer period of time than the year of their actual expenditure.

A more appropriate analysis would indicate administrative costs of about five percent (5%), when calculated on an ongoing basis with one-time and extraordinary claims-adjustment expenses eliminated. This figure is derived by taking the approximate annual expense of about $12 million and dividing it by $236 million in actual revenues to reach an annualized administrative cost of about five percent (5%). (9)

INDIVIDUAL CHAPTER RESPONSES

CHAPTER 1 *"Despite The Lack of Enforcement Authority And Program Stability, The Department Accomplished The Fundamental Purpose Of The Legislation."*

- This is an important chapter because it describes the environment in which the program's implementation, operation, and repeal took place. The Department agrees with the conclusions of this Chapter and the auditor's assessment that this environment created operational and management difficulties and that the Department's focus on completing critical tasks was warranted.

CHAPTER 2 *"The Surcharge Collection Process Was Unduly Complex, Primarily For Reasons Beyond the Department's Control."*

- *Page 21, paragraph 2, "The findings included in this chapter indicate that the surcharge collection process was inefficient and unduly complex."* The surcharge collection process may have been unduly complex, but the Department's process was not inefficient. The inefficiency lay with the legislation that created the program and not with the process that the Department carefully designed and implemented, and later meticulously coordinated with other State agencies and the fiscal intermediary.

- *Page 24, paragraph 3, "This increased CSC's work load and contributed to the contractor's request for the $817,737 change order mentioned previously."* The change order the auditors refer to was caused primarily by late billing on the part of insurers. Work on the change order was begun well before the preparation of the stop-processing order; the stop-processing order did not precipitate the change order.

- *Page 27, paragraph 2, "Although interest payments were not monitored, we did not find evident of widespread abuse of the program's interest provisions by the insurance companies."* The Department and CSC (at the Department's request) did some monitoring of interest payments made by insurers. Those payments were reviewed to see if insurers properly credited the department with interest they noted in the forms submitted to the Department. The Department also conducted two on-site insurer examinations, and the examiners were instructed to check the surcharge submission form for interest paid. (10)

The legislation provided no guidance regarding a rate of interest to be earned and paid to the CRER Fund. Nevertheless, had the Program continued for its expected life, CRER Fund field examiners would have included a review process to assure an appropriate return.

CHAPTER 3 *"The Department Did Not Adequately Perform Its Contract Management Functions"*

The Department of Insurance took a piece of imperfect legislation that required a tough and demanding program implementation schedule, and by methodically focusing on the critical tasks that had to be accomplished to run a good program, collected $236 million in surcharges, paid all claims correctly, closed down the program when and as required, and refunded all remaining money on time and in the right amounts, while reserving for all foreseeable contingencies and leaving no unfunded liabilities.

Despite some of this report's conclusions, it is no exaggeration to say that the Department's handling of the program has been vindicated by the basic finding of this audit: "Despite the lack of enforcement authority and program stability, the Department accomplished the fundamental purpose of the legislation."

The Department has now concluded negotiations with its contractor, Computer Sciences Corporation (CSC), and as a result of those negotiations, CSC has withdrawn all but $100,000 of the $707,678 it originally claimed in its outstanding invoices to the Department.

The accuracy of this and other Chapter sidebars suffers due to their "headline" nature. The sidebars do not quote from the report, they do not accurately characterize the report's detail, and they mislead any reader not already familiar with CRER Fund operations. The sidebars almost invite misquotation, which ultimately distorts both the report and program operations.

- *"The effectiveness of the contract management function was hampered by insufficient staffing." [Page 34, sidebar; see also page 33, paragraph 2, and page 35, paragraph 2]* The goods and services provided by CSC were highly complex, and both CSC and the Department recognized the risk of latent defects and deficiencies in those goods and services. The Department paid CSC invoices when it had ascertained CSC's prima facie compliance with its contractual obligations. However, only actual operation of the CRER Program software and other deliverables over a period of years could fully reveal the sufficiency of CSC's work.

The auditors presume that the Department prejudiced itself by paying CSC's invoices. That presumption is incorrect. The Department never waived any of its legal rights and remedies by paying any of CSC's invoices. The Department's contract with CSC addresses the risk that latent defects in CSC's deliverables and deficiencies in its performance could come to light after the Department paid CSC. Notwithstanding any approvals or payments given by the Department to CSC, the Department retained the right under its contract with CSC to (1) audit or examine various aspects of CSC's performance, (2) pursue recoupment for overpayments, (3) pursue any remedy or relief available under any of its general legal rights and remedies, and (4) demand that CSC remedy defects at its expense. (3)

- *"The Department did not ensure that CSC fulfilled all system-related requirements before authorizing full payment." [Page 36, sidebar]* The Department had been involved in planning and development of the CRER Fund system since December, 1990. Under the contract, CSC could not submit the final development invoice until the system had been operational for six months; that would have been August, 1992. The Department was unwilling to entertain receipt of the final invoice, however, until various crucial requirements had been met, and it made known its position to the contractor. As a result, the contractor worked to fulfill critical requirements, and by October, 1992, the Department was comfortable that critical components were in place.

  What remained were generally modest change orders, minor fixes for a major computer system that in general did not impede functionality and which often were to be done at no cost to the Department. It was decided that they could be implemented later, or possibly not at all, depending on their importance later, and for that reason, the Department deferred the contractor's compliance requirement for those items. This allowed the final payment to be made, and it freed up both the Department and the contractor to concentrate on termination issues, which were myriad.

  In October, 1992, the Department remained highly focused on the critical path issues that would yield an operational system *and* the impending termination of the program. The program manager was aware of the state of the automated system. He determined that while not every requirement had been fully implemented, the system was functional enough to warrant payment while the remaining fixes were made. So he instructed CSC to submit the invoice.

- *"The Department did not require CSC to comply with various claims processing requirements." [Page 38, sidebar]* When the State Controller's Office issued its final report on the entire CRER Fund payment system (for operations conducted from May 1, 1992, through December 31, 1992), it concluded that the payment system was "adequate to ensure financial transactions were properly controlled, processed, recorded, and reported, and payments made were accurate, legal, and proper."

  Due to late surcharge remitting by insurers and earthquakes occurring early in 1992, among other circumstances, the CRER Fund used two, parallel eligibility verification methods, one manual and one automated. It is clear that the auditors did not fully recognize that two systems functioned and did not discern in each case how to pick up evidence of eligibility verification. The Department can effectively and appropriately document, however, that eligibility was always established before any claim payment was made.

  Automated eligibility verification was recognized by the auditor, but in the case of manual eligibility checks, the eligibility verification procedure was different. First, CSC verified eligibility with the insurer. Then, that verification was entered into the computer system and the hard copy separately filed (*not* in the claims file). Later, when claims adjustment was complete and payment called for, the system verified eligibility and allowed payment to be made. The auditor on-site was offered an opportunity to examine the filed verifications but did not do so. Had the auditor had the opportunity to observe the operation of the automated system when it was still running, the report may well have reached a conclusion similar to that of the SCO. (6)

  So, while eligibility documentation may not have been ultimately filed in the claims file, the Department can effectively and appropriately document that before any claims payment was made, claimant program eligibility was reliably documented.

- *"The total claims processing time exceeded the maximum time limit prescribed in the Regulations in* ***more than half*** *of the files in our sample." [Page 38, paragraph 3, bullet 3]* Circumstances noted in the auditor's report contributed to the Department's decision to permit a managed, reasonable extension of time for the contractor to complete a claims payment. The data turned up by the auditor notes an average delay of only eight days (68 days versus 60 days). As stated, this was consistent with the Department's active management of the CSC contract.

It is important to note that in setting the claims payment time limits, the Department opted to hold itself to very tight time limits, much tighter than it requires of any insurance company. Under the adverse conditions under which the CRER Fund operated, that the Department on the average came within eight days of an uniquely short 60-day time limit is a remarkable testament to the efficiency of the system.

- *"The Department did not adequately monitor CSC's TPU charges." [Page 39, sidebar*] Invoices were individually reviewed for reasonableness. But full reconciliation of TPU charges was contemplated for the SCO's annual EDP audit; it was an express part of that process. In the Department's judgment, this method would have proved more than adequate to measure the accuracy of TPU processing, count, and payment. (11)

- *"The termination agreement did not link deliverables or performance criteria with payments limiting the Department's ability to monitor CSC's performance." [Page 40, sidebar]* All performance under the termination agreement was to take place within a time frame of only four months; all deliverables under the termination agreement were grouped at the end of that period. The termination agreement required progress reporting and set forth milestones, and contained a substantial withhold provision to permit the Department to closely assess contractor performance. Finally, the termination agreement preserved all contract remedies and requirements available under the original contract. (4)

This combination of factors allowed the Department to monitor and control all aspects of the contractor's termination phase performance. In fact, after exhaustive post-contract review, the Department withheld $707,678 out of a contract of $4.4 million at the end of the termination phase. The Department has now concluded negotiations with its contractor, Computer Sciences Corporation (CSC), and as a result of those negotiations, CSC has withdrawn all but $100,000 of the $707,678 it originally claimed in its outstanding invoices to the Department, which indicates that the Department's prospective assessment of the situation was accurate.

CHAPTER 4

- *"DOI staff then reviewed the cover sheets on the batches and the Department's Project Manager signed off on the processing accuracy/compliance of batches." [Page 48, paragraph 3]* Claim files ready for the approval process were delivered in batches by CSC to the Department's full time claims examiner. Approximately 30% of all claims decisions were subjected to in-depth, individual file review. All aspects of the file were considered in those reviews, including photographs, adjusters' notes, and every other document or part of the file.

  The project manager reviewed every batch of files. He reviewed the batch cover sheet for consistency with expected claims processing results, and again from the cover sheet, pulled a sample of files of every type of claim represented in that batch. Again, all aspects of each sampled file were considered in that review.

  It may be fair to say that timing of claims payments was not a focus of these reviews, because that issue was handled separately with CSC. (For example, the Department's claims examiner monitored aging reports of the claims under active consideration and consistently pressed CSC to process older claims that appeared on those reports.) The Department's review was as comprehensive as was reasonably necessary to assure the accuracy of every part of the claims decision. That the Department fully reviewed over 4,000 individual claims files, and claims payments have elsewhere been determined to be highly accurate, tend to prove that the CRER Fund claims review process was more effective and more in depth than implied or stated in the audit report.

- *"The eligibility verification process was not properly documented in the claims file and exceeded regulation time limits based on findings on our sample [Page 50, sidebar]."* Due to late surcharge remitting by insurers and earthquakes occurring early in 1992, among other circumstances, there were two, parallel eligibility verification methods used, one manual and one automated. It is clear that the auditors did not fully recognize the two systems functioned and that the "missing" eligibility documents could be found in a separate file. The Department can effectively and appropriately document that eligibility was always established before any claim payment was made. When the SCO issued the final report on its audit of the entire CRER payment system (covering the period May 1, 1992, through December 31, 1992), it concluded that the payment system was "adequate to ensure financial transactions were properly controlled, processed, recorded, and reported, and payments made were accurate, legal, and proper." (2)

CHAPTER 5

- *The documentation of the final pro rata refund reserve methodology and assumptions is not adequately integrated [Page 60, sidebar]*

  The refund process is supported by voluminous documentation, albeit not in a single document, that describes revenue and expense information, reserve accounts, initial pro-rata percentages, refund schedules (amounts verified by region), and exception reports (checks too high or too low, pulled and reviewed for accuracy). (7)

Comments On The Response From The Department Of Insurance

In its response to the audit report, the Department of Insurance provided comments related to specific paragraphs and/or headings in the report. In many instances, the Department repeats its comments when a particular issue is included in more than one place in the report (e.g., in the summary and a specific chapter of the report). When a specific issue is addressed more than one time by the Department, we have provided a single response. For easier reference, circled numbers appear in the Department's response and correspond with numbers beside each comment below.

1. The Department disagrees with the findings in the audit report related to contract management, particularly given the extenuating circumstances which impacted implementation of the program. We agree that there were significant extenuating circumstances which impacted the implementation, operation, and termination of the program, and a detailed discussion of these issues is presented in Chapter 1 of the audit report. We also acknowledge that the Department accomplished the basic purpose of the legislation, which was a significant achievement.

   However, despite the Department's accomplishments and the extenuating circumstances encountered in administering the program, our audit revealed that the contract management function was not adequately performed. Although the impacts of poor contract management were ultimately minimal and almost eleven months after their contract ended CSC agreed to forego all but $100,000 of its final invoice of $707,678, this does not rationalize the Department's performance. Due in part to the Department's poor contract management performance, they were forced to employ outside counsel and a contract management consultant to resolve the dispute. Under different circumstances, the impacts of poor contract management could have negatively impacted the program's overall performance more significantly and required lengthy litigation to resolve.

2. The Department disagrees with the finding that the claims processing function failed to meet requirements established by regulations or policy. Specifically, the Department indicates that we may not have understood some of the

documentation requirements and that we did not recognize that the Department suspended certain processing requirements.

Our understanding of the program's documentation requirements was developed through a review of claims files and interviews with various Department staff members. During the exit interview with Department representatives, our understanding of the program's documentation requirements were again re-affirmed and clarified. We believe that the findings in this report are based on an accurate understanding of the program's documentation requirements.

The program regulations provided timeframes for the completion of certain activities required to process claims. We compared the program's actual performance to these requirements and noted deficiencies as they were identified. As noted previously, Chapter 1 of the audit report provides a discussion of the extenuating circumstances which impacted the program. Despite these issues, the Department was not excused from complying with the timeframes identified in the program regulations.

3. The Department states, "The auditor presumes the Department prejudiced itself by paying CSC invoices." We clearly understood that the Department had various legal rights and remedies available after invoices had been paid. However, we believe that it would have been more prudent for the Department to ensure that all required services and work products had been delivered prior to the payment of corresponding invoices. It is much easier to require that deficient performance be corrected prior to invoice payment than after payment has been made.

4. The Department indicated that a link between deliverables and payments during the termination phase of the project was not required, primarily because most of the deliverables were grouped at the end of the contract and the timeframe for the contract was only four months. In our opinion, these are the very reasons why deliverables should be linked with payments. The termination contract with

CSC totaled $4.4 million. This is a significant level of effort over a very short period of time. Consequently, the contract should have received close monitoring and review to ensure that the contractor's performance was acceptable.

CSC's efforts during both the implementation and termination phases of the program were very similar, with a majority of the deliverables provided at the end of each phase. The Department linked deliverables to payments during the implementation phase of the program, but failed to do so during the termination phase. We believe that the Department should have followed the model used during the implementation phase when negotiating the agreement with CSC for services provided during the termination phase. In addition, the Department indicates that "an exhaustive post contract review" was conducted and resulted in an adjustment to the final invoice submitted by CSC. If deliverables had been linked to payments during the termination phase, this costly review and subsequent adjustment may not have been necessary.

5. The Department infers that the auditor believes there is a direct link between the decision to leave four of five contract management positions vacant and the contract dispute with CSC. While the staffing decisions made by the Department may have had an impact on the contract dispute, we indicate in the report that this is only one of various extenuating circumstances which should be considered. We further indicate that more effective overall contract management possibly could have avoided the current dispute and the extra costs associated therewith. Adequate staffing is only one aspect of more effective overall contract management.

6. The Department indicates that two systems were used to document claimant eligibility and asserts that the audit team was not aware of the relationship between these two systems. Our understanding of the program's documentation requirements was developed through a review of claims files and interviews with various Department staff members. Our understanding of the program's documentation requirements was re-affirmed and clarified during the exit interview with Department representatives. We were clearly aware of both the automated and manual claims processing systems.

It should be noted that we did not have access to the automated claims processing system. In addition, the Department was unable to provide a copy of the program's Claims Processing Manual during the audit, even though we made numerous requests for this document. These two factors complicated our ability to develop an understanding of the claims processing function.

Despite the Department's response, we were not aware that a separate filing system was used to document claimant eligibility until the exit conference with Department representatives was conducted. Based on the additional information received during this meeting, we made several modifications to the audit report. After considering the clarifications that were provided by the Department, we continue to believe that the eligibility documentation in the manual claims files was inconsistent, indicating that the eligibility component of one of the two parallel systems was incomplete.

7. The Department indicated that the final iteration of the refund algorithm percentage was reviewed with the CSC project manager and the use of the percentage was authorized by the Department. Our finding related to this issue simply focused on the fact that this authorization was verbal and not written.

   The Department also indicated that voluminous documentation exists related to the pro rata refund methodology. We would agree that documentation does exist; however, the relationships between these various documents was not clear in all cases. Our finding focused on the lack of a final document which identified the final assumptions used in the process and explained the relationships between the various documents prepared during the process of determining the pro rata refund percentage.

8. In regard to program staffing, we would agree that it was prudent for the Department to hire staff as they were needed and we recognized the extenuating circumstances that impacted the Department's ability to hire and retain qualified staff. However, as discussed in the audit report, we believe that the actual staffing levels were inadequate, particularly during the implementation and operations

phases of the program. We also recognized that the Department was able to utilize staff from other divisions and employ temporary staff during program termination. We believe that the Department also should have utilized these options during the implementation and operations phases of the program.

9. The Department indicates in its response that the audit report fails to fully explain that the administrative cost of the program included expenses for three years compared to revenues for one year. The summary of the report clearly indicates that the administrative cost of the program includes the cost of implementing, operating and terminating the program. In addition, Chapter 6 of the audit report provides a thorough discussion of the assumptions used to determine the administrative cost of the program compared to revenues.

   The Department also states in its response that a more accurate analysis of the administrative cost of the program would indicate that expenses totaled about 5 percent of total revenue. We believe that this figure is low, primarily because a significant amount of data related to surcharge payments was processed after December 31, 1993. These processing costs were included in the termination agreement; however, they are not separately identified. These additional costs would have been incurred regardless of whether the program was terminated or not, and should be considered operating costs. However, because the surcharge processing cost data was not segregated, we could not determine the percentage of operating expenses in relation to total revenue.

10. The Department claims that some monitoring of interest payments did occur. However, Department representatives could not provide documentation of these monitoring activities.

11. The Department reiterates in its response that a full reconciliation of TPU charges was contemplated to be part of the annual EDP audit and that additional reviews of TPU charges were unnecessary during the operation of the Program. Given that the cost of processing surcharge data

averaged approximately $1 million per month, we believe that the Department should have made a more concerted effort to reconcile each invoice with the work conducted by CSC. An error in the TPU count could have resulted in a significant overpayment or underpayment, which would not have been discovered until the annual EDP audit was conducted.

cc: Members of the Legislature
Office of the Lieutenant Governor
Attorney General
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps